Rosetta Resources Inc.
Form 10-Q
November 14, 2006

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, 2006

OR

[ ] Transition Report Pursuant To Section 15(d) of The Securities Exchange Act of 1934

Commission File Number: 000-51801

ROSETTA RESOURCES INC.
(Exact name of registrant as specified in its charter)

Delaware	**43-2083519**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
717 Texas, Suite 2800, Houston, TX	**77002**
(Address of principal executive offices)	**(Zip Code)**

Registrant's telephone number, including area code: **(713) 335-4000**

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Securities Exchange Act of 1934. Large accelerated filer [ ] Accelerated filer [ ] Non-Accelerated filer [X]

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Securities Exchange Act of 1934). Yes [ ] No [X]

The number of shares of the registrant's Common Stock, $.001 par value per share, outstanding as of November 2, 2006 was 50,647,319.

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Rule 13a-14(a) Certification executed by B.A. Berilgen		
Rule 13a-14(a) Certification executed by Michael J. Rosinski		
Section 1350 Certification		

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Part I. Financial Information
Item 1. Financial Statements

Rosetta Resources Inc.
Consolidated Balance Sheet
(In thousands, except share amounts)

Assets	**September 30, 2006 (Unaudited)**	**December 31, 2005**
Current assets:		
Cash and cash equivalents	$ 78,743	$ 99,724
Restricted cash	15,000	-
Accounts receivable	34,751	40,051
Derivative instruments	23,591	1,110
Deferred income taxes	-	10,962
Income tax receivable	-	6,000
Other current assets	9,696	9,411
Total current assets	161,781	167,258
Oil and natural gas properties, full cost method, of which $51.0 million at September 30, 2006 and $30.6 million at December 31, 2005 were excluded from amortization	1,134,754	973,185
Other	3,868	2,912
	1,138,622	976,097
Accumulated depreciation, depletion, and amortization	(117,186)	(40,161)
Total property and equipment, net	1,021,436	935,936
Deferred loan fees	3,670	4,555
Deferred income taxes	-	8,594
Other assets	3,458	2,926
	7,128	16,075
Total assets	$ 1,190,345	$ 1,119,269
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 16,604	$ 13,442
Accrued liabilities	42,604	28,397
Royalties payable	13,479	15,511
Derivative instruments	-	29,957
Prepayment on gas sales	10,599	14,528
Deferred income taxes	8,965	-
Total current liabilities	92,251	101,835
Long-term liabilities:		
Derivative instruments	7,952	52,977
Long-term debt	240,000	240,000
Asset retirement obligation	9,698	9,034
Deferred income taxes	28,179	-
Total liabilities	378,080	403,846
Commitments and contingencies (Note 10)		

Stockholders' equity:				
Common stock, $0.001 par value, 150,000,000 shares authorized; 50,380,475 issued		50		50
Additional paid-in capital		754,002		748,569
Treasury stock, at cost; 83,881 and no shares at September 30, 2006 and December 31, 2005, respectively		(1,526)		-
Accumulated other comprehensive income (loss)		10,792		(50,731)
Retained earnings		48,947		17,535
Total stockholders' equity		812,265		715,423
Total liabilities and stockholders' equity	$	1,190,345	$	1,119,269

The accompanying notes to the financial statements are an integral part hereof.

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Rosetta Resources Inc.
Consolidated/Combined Statement of Operations
(In thousands, except per share amounts)
(Unaudited)

	Successor-Consolidated		Successor-Consolidated	Predecessor-Combined
	Three Months Ended September 30,		Nine Months Ended September 30,	Six Months Ended June 30,
	2006	2005	2006	2005
Revenues:				
Natural gas sales	$ 61,366	$ 51,661	$ 171,783	$ 13,713
Oil sales	9,831	6,204	27,339	8,166
Oil and natural gas sales to affiliates	-	-	-	81,952
Total revenues	71,197	57,865	199,122	103,831
Operating Costs and Expenses:				
Lease operating expense	9,449	8,849	27,330	16,629
Depreciation, depletion, and amortization	27,906	21,720	77,574	30,679
Exploration expense	-	-	-	2,355
Dry hole costs	-	-	-	1,962
Treating and transportation	317	552	2,043	1,998
Affiliated marketing fees	-	-	-	913
Marketing fees	526	678	1,634	-
Production taxes	2,153	1,946	5,476	2,755
General and administrative costs	8,316	6,880	24,645	9,677
Total operating costs and expenses	48,667	40,625	138,702	66,968
Operating income	22,530	17,240	60,420	36,863
Other (income) expense				
Interest expense with affiliates, net of interest capitalized	-	-	-	6,995
Interest expense, net of interest capitalized	4,557	4,077	13,060	-
Interest (income) expense	(1,099)	(874)	(3,351)	(516)
Other (income) expense, net	(171)	153	6	207
Total other expense	3,287	3,356	9,715	6,686
Income before provision for income taxes	19,243	13,884	50,705	30,177
Provision for income taxes	7,321	5,677	19,293	11,496
Net income	$ 11,922	$ 8,207	$ 31,412	$ 18,681
Earnings per share:				
Basic	$ 0.24	$ 0.16	$ 0.63	$ 0.37
Diluted	$ 0.24	$ 0.16	$ 0.62	$ 0.37
Weighted average shares outstanding:				

Basic	50,282	50,000	50,211	50,000
Diluted	50,426	50,160	50,384	50,160

The accompanying notes to the financial statements are an integral part hereof.

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Rosetta Resources Inc.
Consolidated/Combined Statement of Cash Flows
(In thousands)
(Unaudited)

	Successor-Consolidated	Successor-Consolidated	Predecessor-Combined
	Nine Months Ended September 30, 2006	Three Months Ended September 30, 2005	Six Months Ended June 30, 2005
Cash flows from operating activities			
Net income	$ 31,412	$ 8,207	$ 18,681
Adjustments to reconcile net income to net cash from operating activities			
Depreciation, depletion and amortization	77,574	21,720	30,679
Affiliate interest expense	-	-	(6,995)
Deferred income taxes	18,991	3,406	2,874
Amortization of deferred loan fees recorded as interest expense	885	-	-
Income from unconsolidated investments	(168)	(112)	(161)
Stock compensation expense	4,348	1,710	-
Other non-cash charges	-	-	99
Change in operating assets and liabilities:			
Accounts receivable	5,300	(33,570)	2,378
Accounts receivable from affiliates	-	-	6,298
Income taxes receivable	6,000	-	-
Other assets	1,070	(5,412)	2,563
Accounts payable	2,494	24,098	(4,494)
Accrued liabilities	(324)	8,019	241
Royalties payable	(5,961)	32,913	(1,406)
Income taxes payable	-	2,271	8,622
Net cash provided by operating activities	141,621	63,250	59,379
Cash flows from investing activities			
Acquisition, net of cash acquired	-	(910,064)	-
Purchases of property and equipment	(147,243)	(26,507)	(32,202)
Disposals of property and equipment	36	-	1,447
Deposits	50	(201)	-
Investment in non-affiliated subsidiary	-	(820)	-
Increase in restricted cash	(15,000)	-	-
Other	(4)	-	110
Net cash used in investing activities	(162,161)	(937,592)	(30,645)
Cash flows from financing activities			
Equity offering proceeds	-	800,000	-
Equity offering transaction fees	268	(53,540)	-
Borrowings on term loan	-	100,000	-

Payments on term loan		-		(25,000)	-
Borrowings on revolving credit facility		-		225,000	-
Payments on revolving credit facility		-		(60,000)	-
Loan fees		-		(5,145)	-
Notes payable to affiliates		-		-	(27,239)
Proceeds from issuances of common stock		515		-	-
Stock-based compensation excess tax benefit		302		-	-
Purchases of treasury stock		(1,526)		-	-
Net cash (used in) provided by financing activities		(441)		981,315	(27,239)
Net (decrease) increase in cash		(20,981)		106,973	1,495
Cash and cash equivalents, beginning of period		99,724		-	-
Cash and cash equivalents, end of period	$	78,743	$	106,973	$ 1,495
Supplemental non-cash disclosures:					
Capital expenditures included in accrued liabilities	$	3,783		(1,670)	-
Accrued purchase price adjustment		11,400			

The accompanying notes to the financial statements are an integral part hereof

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Rosetta Resources Inc.

Notes to Consolidated/Combined Financial Statements (unaudited)

(1) Organization and Operations of the Company

Nature of Operations. Rosetta Resources Inc. (together with its consolidated subsidiaries, "the Company") was formed in June 2005. The Company ("Successor") is engaged in oil and natural gas exploration, development, production, and acquisition activities in the United States. The Company's main operations are primarily concentrated in the Sacramento Basin of California, the Lobo and Perdido Trends in South Texas, the Gulf of Mexico and the Rocky Mountains.

These interim financial statements have not been audited. However, in the opinion of management, all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the financial statements have been included. Results of operations for interim periods are not necessarily indicative of the results of operations that may be expected for the entire year. In addition, these financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all disclosures required for financial statements prepared in conformity with accounting principles generally accepted in the United States of America.

These financial statements and notes should be read in conjunction with the Company's audited consolidated/combined financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

Certain reclassifications of prior year balances have been made to conform such amounts to corresponding 2006 classifications. These reclassifications have no impact on net income.

(2) Acquisition of Calpine Oil and Natural Gas Business

On July 7, 2005, the Company acquired substantially all of the oil and natural gas business of Calpine Corporation and certain of its subsidiaries (collectively, "Calpine" or "Predecessor"), excluding certain non-consent properties described below, for approximately $910 million. This acquisition (the "Acquisition") was funded with the issuance of common stock totaling $725 million and $325 million of debt from the Company's credit facilities. The transaction was accounted for under the purchase method in accordance with Statement of Financial Accounting Standards ("SFAS") No.141. The results of operations were included in the Company's financial statements effective July 1, 2005 as the operating results in the intervening period were not significant. The purchase price in the Acquisition was calculated as follows (In thousands):

Cash from equity offering	$	725,000
Proceeds from revolver		225,000
Proceeds from term loan		100,000
Other purchase price costs		(53,389)
Transaction adjustments (purchase price adjustments)		(11,556)
Transaction adjustments (non-consent properties)		(74,991)
Initial purchase price	$	910,064

Other purchase price costs relate primarily to professional fees of $3.9 million and other direct transaction costs of $49.5 million.

The transaction adjustments (purchase price adjustments) referred to above are an amount agreed upon by Calpine and the Company to cover potential costs and/or revenues to be adjusted to actual upon the final settlement.

Transaction adjustments (non-consent properties) referred to above relate to properties which Calpine determined required third party consents or waivers of preferential purchase rights in order to effect the transfer of title from Calpine to the Company or to Calpine entities acquired by the Company in the Acquisition (collectively, "Non-Consent Properties"). At July 7, 2005, the Company withheld approximately $75 million of the purchase price with respect to the Non-Consent Properties. A third party exercised a preferential right to purchase certain Non-Consent Properties. Assuming such preferential rights transaction is consummated, these properties will not be conveyed to the Company, and the purchase price of the remaining Non-Consent properties will be reduced by approximately $7.4 million. Despite Calpine's bankruptcy filing, management believes that it remains likely that conveyance to the Company of substantially all of the remaining Non-Consent Properties will occur. Upon conveyance of the remaining Non-Consent Properties, approximately $68 million, the balance of the additional purchase price, will be paid to Calpine and will be incremental to the purchase price of $910 million. The Company has excluded the effects of the operating results for the Non-Consent Properties from the Company's actual results for the three and nine months ended September 30, 2006. If the assignment of the remaining Non-Consent Properties does not occur, the portion of the purchase price the Company withheld pending obtaining consent or waivers for these properties will be available to the Company for general corporate purposes or to acquire other properties.

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The following is the allocation of the purchase price to specific assets acquired and liabilities assumed based on estimates of the fair values and costs (In thousands). There was no goodwill associated with the transaction.

Current assets	$	1,794
Non-current assets		5,087
Properties, plant and equipment		925,141
Current liabilities		(14,390)
Long-term liabilities		(7,568)
	$	910,064

The purchase price allocation is based upon the manner in which the parties expect to resolve the negotiation associated with the Company's revised Final Settlement Statement pertaining to the Acquisition that was delivered to Calpine on May 12, 2006. In addition to the $68 million that will be payable to Calpine if and when title is obtained by the Company for the remaining Non-Consent Properties and Calpine provides the further assurances to eliminate any open issues on title to the remaining properties that may require further documentation, the Company's revised Final Settlement Statement includes the proposed cash payment to Calpine of approximately $11 million arising from net revenues that were estimated and withheld at the closing of the Acquisition, which is recorded as an accrued liability on the Consolidated Balance Sheet as of September 30, 2006.

The unaudited pro forma information for the nine months ended September 30, 2005 assumes the acquisition of Calpine's domestic oil and natural gas business and the related financings occurred on January 1, 2004. The Company believes the assumptions used provide a reasonable basis for presenting the significant effects directly attributable to such transactions. The unaudited pro forma financial statements do not purport to represent what the Company's results of operations would have been if such transactions had occurred on such date.

		Nine Months Ended September 30, 2005 (In thousands, except per share amounts) (Unaudited)
Revenues	$	152,262
Net income		17,109
Basic earnings per common share		0.34
Diluted earnings per common share	$	0.34

(3) Summary of Significant Accounting Policies

The Company has provided discussion of significant accounting policies, estimates and judgments in its Annual Report on Form 10-K for the year ended December 31, 2005.

Principles of Consolidation/Combination and Basis of Presentation. The Predecessor combined financial statements for the six months ended June 30, 2005 have been prepared from the historical accounting records of the domestic oil and natural gas business of Calpine and are presented on a carve-out basis to include the historical operations of the domestic oil and natural gas business. The domestic oil and natural gas business of Calpine was separately accounted

for and managed through direct and indirect subsidiaries of Calpine. The combined financial information included herein includes certain allocations based on the historical activity levels to reflect the combined financial statements in accordance with accounting principles generally accepted in the United States of America and may not necessarily reflect the financial position, results of operations and cash flows of the Company in the future or as if the Company had existed as a separate, stand-alone business during the period presented. The allocations consist of general and administrative expenses such as employee payroll and related benefit costs and building lease expense, which were incurred on behalf of Calpine. The allocations have been made on a reasonable basis and have been consistently applied for the periods presented.

The accompanying consolidated financial statements as of September 30, 2006 and December 31, 2005 and for the three and nine months ended September 30, 2006 and three months ended September 30, 2005 contain the accounts of Rosetta Resources Inc. and its majority owned subsidiaries after eliminating all significant intercompany balances and transactions.

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Stock-Based Compensation. On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004) “Share-Based Payments” (“SFAS No. 123R”). This statement applies to all awards granted, modified, repurchased or cancelled after January 1, 2006 and to the unvested portion of all awards granted prior to that date. The Company adopted this statement using the modified version of the prospective application (modified prospective application). Under the modified prospective application, compensation cost for the portion of awards for which the employee’s requisite service has not been rendered that are outstanding as of January 1, 2006 must be recognized as the requisite service is rendered on or after that date. The compensation cost for that portion of awards shall be based on the original fair market value of those awards on the date of grant as calculated for recognition under SFAS No. 123 “Accounting for Stock-Based Compensation” as amended by SFAS No. 148, “Accounting for Stock-Based Compensation - Transition and Disclosure” (“SFAS No. 123”). The compensation cost for these earlier awards shall be attributed to periods beginning on or after January 1, 2006 using the attribution method that was used under SFAS 123.

The adoption of the new standard did not have a significant impact on the Consolidated Balance Sheet because of the requirement to decrease retained earnings with an offsetting increase in additional paid-in capital. On the Consolidated/Combined Statement of Operations, the adoption of SFAS No. 123R resulted in decreases in both income before income taxes and net income of $1.0 million and $0.6 million, respectively, for the three months ended September 30, 2006 and $4.3 million and $2.7 million, respectively, for the nine months ended September 30, 2006. The effect on net income per share for basic and diluted was a reduction $0.01 and $0.05 for the three and nine months ended September 30, 2006, respectively. See Note 12 of the notes to the Consolidated/Combined Financial Statements for additional disclosure.

Prior to the adoption of SFAS No. 123R, the Company presented all tax benefit deductions resulting from the exercise of stock options as operating cash flows in the accompanying Consolidated/Combined Statement of Cash Flows. SFAS No. 123R requires the cash flows that result from tax deductions in excess of the compensation expense recognized as an operating expense in 2006 and reported in pro forma disclosures prior to 2006 for those stock options (excess tax benefits) to be classified as financing cash flows. The excess tax benefit for the nine months ended September 30, 2006 was $0.3 million.

Recent Accounting Developments

Accounting Changes and Error Corrections. In May 2005, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 154, “Accounting Changes and Error Corrections - a replacement of Accounting Principles Board Opinion (“APB”) No. 20 and FASB Statement No. 3” (“SFAS No. 154”), which changes the requirements for the accounting for and the reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principles. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of this Statement did not impact the Company’s consolidated financial position, results of operations, or cash flows.

Accounting for Certain Hybrid Financial Instruments. In February 2006 , the FASB issued SFAS No. 155, “Accounting for Certain Hybrid Instruments - an amendment of FASB Statements 133 and 140”, which is effective for all financial instruments acquired or issued after the beginning of an entity’s first fiscal year that begins after September 15, 2006. The statement improves financial reporting by eliminating the exemption from applying SFAS No. 133 to interests in securitized financial assets so that similar instruments are accounted for similarly regardless of the form of the instruments. The statement also improves financial reporting by allowing a preparer to elect fair value measurement at acquisition, at issuance, or when a previously recognized financial instrument is subject to a re-measurement event, on an instrument-by-instrument basis, in cases in which a derivative would otherwise have to be bifurcated, if the holder elects to account for the whole instrument on a fair value basis. The adoption of this

statement is not expected to have a material impact on the Company's consolidated financial position, results of operations, or cash flows.

Accounting for Uncertainty in Income Taxes. In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN 48"). This interpretation provides guidance for recognizing and measuring uncertain tax positions, as defined in SFAS No. 109, "Accounting for Income Taxes." FIN 48 prescribes a threshold condition that a tax position must meet for any of the benefit of the uncertain tax position to be recognized in the financial statements. Guidance is also provided regarding derecognition, classification and disclosure of these uncertain tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006. The adoption of this Interpretation is not expected to have a material impact on the Company's consolidated financial position, results of operations, or cash flows.

Guidance for Quantifying Financial Statement Misstatement. In September 2006, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"), which establishes an approach requiring the quantification of financial statement errors based on the effect of the error on each of the company's financial statements and the related financial statement disclosures. This model is commonly referred to as a "dual approach" because it requires quantification of errors under both the "iron curtain" and "roll-over" methods. The

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roll-over method focuses primarily on the impact of a misstatement on the income statement, including the reversing effect of prior year misstatements; however, its use can lead to the accumulation of misstatements in the balance sheet. The iron curtain method focuses primarily on the effect of correcting the period end balance sheet with less emphasis on the reversing effects of prior year errors on the income statement. The Company currently uses the iron curtain method for quantifying financial statement misstatements. The Company will initially apply the provisions of SAB 108 in connection with the preparation of the Company's annual financial statements for the year ending December 31, 2006. The use of the dual approach is not expected to have a material impact on the Company's consolidated financial position, results of operations, or cash flows.

Fair Value Measurements. In September 2006, the FASB issued FASB Statement No. 157,"Fair Value Measurements" ("SFAS No. 157"), which addresses how companies should measure fair value when companies are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles ("GAAP"). As a result of SFAS No. 157, there is now a common definition of fair value to be used throughout GAAP. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those years. Although the disclosure requirements may be expanded where certain assets or liabilities are fair valued such as those related to stock compensation expense and hedging activities, the Company does not expect the adoption of SFAS No. 157 to have a material impact on the Company's consolidated financial position, results of operations, or cash flows.

(4) Restricted Cash

In July 2006, the Company entered into a Deposit Account Control Agreement in order to provide a security interest under the terms of its senior secured revolving line of credit. Under the terms of the Deposit Account Control Agreement, the Company was required to maintain $15.0 million on account to keep a borrowing base of $325.0 million. The Company's borrowing base is subject to review on a semi-annual basis under the terms of the senior secured revolving line of credit. Based on this semi-annual review, a consent agreement was signed in October 2006 in which the borrowing base remained at $325.0 million and the Company was no longer required to maintain the $15.0 million balance pursuant to the Deposit Account Control Agreement.

(5) Property, Plant and Equipment

In connection with the Company's separation from Calpine, the Company adopted the full cost method of accounting for oil and natural gas properties beginning July 1, 2005. Under the full cost method, all costs incurred in acquiring, exploring and developing properties within a relatively large geopolitical cost center are capitalized when incurred and are amortized as mineral reserves in the cost center are produced, subject to a limitation that the capitalized costs not exceed the value of those reserves. In some cases, however, certain significant costs, such as those associated with offshore U.S. operations, are deferred separately without amortization until the specific property to which they relate is found to be either productive or nonproductive, at which time those deferred costs and any reserves attributable to the property are included in the computation of amortization in the cost center. All costs incurred in oil and natural gas producing activities are regarded as integral to the acquisition, discovery and development of whatever reserves ultimately result from the efforts as a whole, and are thus associated with the Company's reserves. The Company capitalizes internal costs directly identified with acquisition, exploration and development activities. The Company capitalized $0.9 million and $2.6 million of internal costs for the three and nine months ended September 30, 2006, respectively. Unevaluated costs are excluded from the full cost pool and are periodically evaluated for impairment rather than amortized. Upon evaluation, costs associated with productive properties are transferred to the full cost pool and amortized. Gains or losses on the sale of oil and natural gas properties are generally included in the full cost pool unless a significant portion of the pool is sold.

The Company assesses the impairment for oil and natural gas properties for the full cost pool quarterly using a ceiling test to determine if impairment is necessary. If the net capitalized costs of oil and natural gas properties exceed the cost center ceiling, the Company is subject to a ceiling test write-down to the extent of such excess. A ceiling test write-down is a charge to earnings and cannot be reinstated even if the cost ceiling increases at a subsequent reporting date. If required, it would reduce earnings and impact shareholders' equity in the period of occurrence and result in a lower depreciation, depletion and amortization expense in the future.

The Company's ceiling test computation was calculated using hedge adjusted market prices at September 30, 2006 which were based on a Henry Hub gas price of $4.18 per MMBtu and a West Texas Intermediate oil price of $62.91 per barrel. The use of these prices indicated a writedown of $142.1 million at September 30, 2006. Cash flow hedges of natural gas production in place at September 30, 2006 increased the calculated ceiling value by approximately $92.2 million (net of tax). However, subsequent to September 30, 2006 the market price for Henry Hub increased to $7.42 per MMBtu and the price for West Texas Intermediate decreased to $58.07 per barrel, and utilizing these prices, the Company's net capitalized costs of oil and natural gas properties exceeded the ceiling amount. As a result no writedown was recorded for the quarter ended September 30, 2006. The ceiling value calculated using subsequent prices includes approximately $17.9 million related to the positive effects of future cash flow hedges of natural gas production. Due to the volatility of commodity prices, should natural gas and oil prices decline in the future, it is possible that a writedown could occur.

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Calpine followed the successful efforts method of accounting for oil and natural gas activities. Under the successful efforts method, lease acquisition costs and all development costs were capitalized. Exploratory drilling costs were capitalized until the results were determined. If proved reserves were not discovered, the exploratory drilling costs were expensed. Other exploratory costs were expensed as incurred. Interest costs related to financing major oil and natural gas projects in progress were capitalized until the projects were evaluated or until the projects were substantially complete and ready for their intended use if the projects were evaluated as successful. Calpine also capitalized internal costs directly identified with acquisition, exploration and development activities and did not include any costs related to production, general corporate overhead or similar activities. The provision for depreciation, depletion, and amortization was based on the capitalized costs as determined above, plus future abandonment costs net of salvage value, using the unit of production method with lease acquisition costs amortized over total proved reserves and other costs amortized over proved developed reserves.

The Company’s total property, plant and equipment consists of the following:

	September 30, 2006	December 31, 2005
	(In thousands)	
Proved properties	$ 1,103,302	$ 951,968
Unproved properties	31,452	21,217
Other	3,868	2,912
Total	1,138,622	976,097
Less: Accumulated depreciation, depletion, and amortization	(117,186)	(40,161)
	$ 1,021,436	$ 935,936

Included in the Company’s oil and natural gas properties are asset retirement obligations of $9.2 million and $9.1 million as of September 30, 2006 and December 31, 2005, respectively.

At September 30, 2006 and December 31, 2005, the Company excluded the following capitalized costs from depreciation, depletion and amortization:

	September 30, 2006	December 31, 2005
Onshore:	(In thousands)	
Development cost	$ 13,796	$ 1,716
Exploration cost	3,939	5,212
Acquisition cost of undeveloped acreage	25,696	19,684
Capitalized interest	1,691	555
Total	45,122	27,167
Offshore:		
Development cost	$ 1,779	$ -
Exploration cost	-	2,407
Acquisition cost of undeveloped acreage	3,954	950
Capitalized interest	111	28
Total	5,844	3,385

Total costs excluded from depreciation, depletion, and amortization	$	50,966	$	30,552

In April 2006, the Company acquired certain oil and gas producing non-operated properties located in Duval, Zapata, and Jim Hogg Counties, Texas and Escambia County in Alabama from Contango Oil and Gas for $11.6 million in cash.

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(6) Commodity Hedging Contracts and Other Derivatives

In the third quarter of 2006, the Company entered into two additional financial fixed price swaps with prices ranging from $7.99 per MMBtu to $8.23 per MMBtu covering a portion of the Company's 2007 and 2008 production. The following financial fixed price swaps were outstanding with average underlying prices that represent hedged prices of commodities at various market locations at September 30, 2006:

Settlement Period	Derivative Instrument	Hedge Strategy	Notional Daily Volume MMBtu	Total of Notional Volume MMBtu	Average Underlying Prices MMBtu	Total of Proved Natural Gas Production Hedged (1)	Fair Market Value Gain/(Loss) (In thousands)
2006	Swap	Cash flow	45,000	4,140,000	$ 7.92	46%	$ 11,176
2007	Swap	Cash flow	45,341	16,549,500	7.87	41%	7,593
2008	Swap	Cash flow	39,909	14,606,616	7.63	35%	(2,060)
2009	Swap	Cash flow	26,141	9,541,465	6.99	26%	(4,398)
				44,837,581			$ 12,311

(1) Estimated based on net gas reserves presented in the December 31, 2005 Netherland, Sewell, & Associates, Inc. reserve report.

In the third quarter of 2006, the Company entered into two additional costless collar transactions with an average floor price of $7.19 per MMBtu and an average ceiling price of $10.03 per MMBtu covering a portion of the Company's 2007 production. The following costless collar transactions were outstanding with associated notional volumes and contracted ceiling and floor prices that represent hedge prices at various market locations at September 30, 2006:

Settlement Period	Derivative Instrument	Hedge Strategy	Notional Daily Volume MMBtu	Total of Notional Volume MMBtu	Average Floor Price MMBtu	Average Ceiling Price MMBtu	Fair Market Value Gain/(Loss) (In thousands)
2006	Costless Collar	Cash flow	10,000	920,000	$ 8.83	$ 14.00	$ 3,175
2007	Costless Collar	Cash flow	10,000	3,650,000	7.19	$ 10.03	1,922
				4,570,000			$ 5,097

The total of proved natural gas production hedged in 2006 and 2007 for the costless collars is approximately 10% and 9%, respectively, based on the December 31, 2005 reserve report prepared by Netherland, Sewell, & Associates, Inc.

The Company's current cash flow hedge positions are with counterparties who are lenders in the Company's credit facilities. This eliminates the need for independent collateral postings with respect to any margin obligation resulting from a negative change in fair market value of the derivative contracts in connection with the Company's hedge related credit obligations. As of September 30, 2006, the Company made no deposits for collateral.

The following table sets forth the results of third party hedge transactions for the respective period for the Consolidated Statement of Operations:

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Natural Gas		
Quantity settled (MMBtu)	5,060,000	15,015,000
Increase in natural gas sales revenue (In thousands)	$ 9,114	$ 19,804

The Company expects to reclassify gains of $14.6 million based on market pricing as of September 30, 2006 to earnings from the balance in accumulated other comprehensive income (loss) on the Consolidated Balance Sheet during the next twelve months.

At September 30, 2006, the Company had derivative assets of $25.4 million of which $1.8 million is included in other assets on the Consolidated Balance Sheet. The Company also had derivative liabilities of $8.0 million on the Consolidated Balance Sheet at September 30, 2006. The derivative instrument assets and liabilities relate to commodity hedges that represent the difference between hedged prices and market prices on hedged volumes of the commodities as of September 30, 2006. Hedging activities related to cash settlements on commodities increased revenues by $9.1 million and $19.8 million for the three and nine months ended September 30, 2006.

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Gains and losses related to ineffectiveness and derivative instruments not designated as hedging instruments are included in other income (expense). There was no ineffectiveness related to cash-flow hedges recorded for the three and nine months ended September 30, 2006 or for the three months ended September 30, 2005. There were no gains or losses related to derivative instruments not designated as hedged instruments for the six months ended June 30, 2005 (Predecessor) as no derivative instruments existed.

(7) Accrued Liabilities

The Company’s accrued liabilities consists of the following:

	September 30, 2006	December 31, 2005
	(In thousands)	
Accrued capital costs	$ 19,201	$ 17,607
Accrued Calpine settlement	11,400	-
Accrued lease operating expense	7,658	3,202
Accrued payroll and employee incentive expense	2,181	2,696
Other	2,164	4,892
Total	$ 42,604	$ 28,397

(8) Asset Retirement Obligation

Activity related to the Company’s asset retirement obligation (“ARO”) is as follows:

	Nine Months Ended September 30, 2006 (In thousands)
ARO as of January 1, 2006	$ 9,467
Liabilities incurred during period	115
Liabilities settled during period	(15)
Accretion expense	587
Other Adjustments	(4)
ARO as of September 30, 2006	$ 10,150

Of the total ARO, approximately $0.5 million is classified as a current liability at September 30, 2006.

(9) Long-Term Debt

The Company’s credit facilities consist of a four-year senior secured revolving line of credit of up to $400.0 million with a borrowing base of $325.0 million and a five-year $75.0 million senior second lien term loan. All amounts drawn under the revolver are due and payable on July 7, 2009. The principal balance associated with the senior secured lien term loan is due and payable on July 7, 2010.

On September 30, 2006, the Company had outstanding borrowings and letters of credit of $240.0 million and $1.0 million, respectively. Net borrowing availability was $159.0 million at September 30, 2006. The Company was in compliance with all covenants at September 30, 2006.

(10) Commitment and Contingencies

The Company is party to various oil and natural gas litigation matters arising out of the normal course of business. The ultimate outcome of each of these matters cannot be absolutely determined, and the liability the Company may ultimately incur with respect to any one of these matters in the event of a negative outcome may be in excess of amounts currently accrued with respect to such matters. Management does not believe any such matters will have a material adverse effect on the Company’s financial position, results of operations or cash flows.

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Calpine Bankruptcy

Calpine Corporation and certain of its subsidiaries filed for protection under the federal bankruptcy laws in the United States Bankruptcy Court of the Southern District of New York (the "Court") on December 20, 2005. Calpine Energy Services, L.P., which filed for bankruptcy, has continued to make the required deposits into the Company's margin account and to timely pay for natural gas production it purchases from the Company's subsidiaries under various natural gas supply agreements. As part of the Acquisition, Calpine and the Company entered into a Transition Services Agreement, pursuant to which both parties were to provide certain services for the other for various periods of time. Calpine's obligation to provide services under the Transition Services Agreement ceased on July 6, 2006 and certain of Calpine's services ceased prior to the conclusion of the contract, which in neither case had any material effect on the Company. Additionally, Calpine Producer Services, L.P., which filed for bankruptcy, generally is performing its obligations under the Marketing and Services Agreement with the Company.

There remains the possibility, however, that there will be issues between the Company and Calpine that could amount to material contingencies in relation to the Purchase and Sale Agreement and interrelated agreements concurrently executed therewith, dated July 7, 2005, by and among Calpine, the Company, and various other signatories thereto (collectively, the "Purchase Agreement"), including unasserted claims and assessments with respect to (i) the still pending Purchase Agreement and the amounts that will be payable in connection therewith, (ii) whether or not Calpine and its affiliated debtors will, in fact, perform their remaining obligations in connection with the Purchase Agreement; and (iii) the ultimate disposition of the remaining Non-Consent Properties (and related royalty revenues). Calpine has specific obligations to the Company under the Purchase Agreement relating to these matters, and also has "further assurances" duties to the Company under the Purchase Agreement.

In addition, as to certain of the other oil and natural gas properties the Company purchased from Calpine in the Acquisition and for which payment was made on July 7, 2005, the Company will seek additional documentation from Calpine to eliminate any open issues in the Company's title or resolve any issues as to the clarity of the Company's ownership. Requests for additional documentation are customary in connection with transactions similar to the Acquisition. In the Acquisition, certain of these properties require ministerial governmental action approving the Company as qualified assignee and operator, which is typically required even though in most cases Calpine has already conveyed the properties to the Company free and clear of mortgages and liens in favor of Calpine's creditors. As to certain other properties, the documentation delivered by Calpine at closing under the Purchase Agreement was incomplete. The Company remains hopeful that Calpine will continue to work cooperatively with the Company to secure these ministerial governmental approvals and to accomplish the curative corrections for all of these properties. In addition, as to all properties acquired by the Company in the Acquisition, Calpine contractually agreed to provide the Company with such further assurances as the Company may reasonably request. Nevertheless, as a result of Calpine's bankruptcy filing, it remains uncertain as to whether Calpine will respond cooperatively. If Calpine does not fulfill its contractual obligations and does not complete the documentation necessary to resolve these issues, the Company will pursue all available remedies, including but not limited to a declaratory judgment to enforce the Company's rights and actions to quiet title. After pursuing these matters, if the Company experiences a loss of ownership with respect to these properties without receiving adequate consideration for any resulting loss to the Company, an outcome the Company's management considers to be remote, then the Company could experience losses which could have a material adverse effect on the Company's financial condition, statement of operations and cash flows.

On June 29, 2006, Calpine filed a motion in connection with its pending bankruptcy proceeding in the Court seeking the entry of an order authorizing Calpine to assume certain oil and natural gas leases Calpine has previously sold or agreed to sell to the Company in the Acquisition, to the extent those leases constitute "unexpired leases of non-residential real property" and were not fully transferred to the Company at the time of Calpine's filing for bankruptcy. According to this motion, Calpine filed the motion in order to avoid the automatic forfeiture of any interest it may have in these leases by operation of a statutory deadline. Calpine's motion did not request that the Court

determine whether these properties belong to the Company or Calpine, but the Company understands it was meant to allow Calpine to preserve and avoid forfeiture under the Bankruptcy Code of whatever interest Calpine may possess, if any, in these oil and natural gas leases. The Company disputes Calpine's contention that it may have an interest in any significant portion of these oil and natural gas leases and intends to take the necessary steps to protect all of the Company's rights and interest in and to the leases. On July 7, 2006, the Company filed an objection in response to Calpine's motion, wherein the Company asserted that oil and natural gas leases constitute interests in real property that are not subject to "assumption" under the Bankruptcy Code. In the objection the Company also requested that (a) the Court eliminate from the order certain Federal offshore leases from the Calpine motion because these properties were fully conveyed to the Company in July 2005, and the Minerals Management Service has subsequently recognized the Company as owner and operator of these properties, and (b) any order entered by the Court be without prejudice to, and fully preserve the Company's rights, claims and legal arguments regarding the characterization and ultimate disposition of the remaining described oil and natural gas properties. In the Company's objection, the Company also urged the Court to require the parties to promptly address and resolve any remaining issues under the pre-bankruptcy definitive agreements with Calpine and proposed to the Court that the parties seek arbitration (or at least mediation) to complete the following:

- Calpine's conveyance of the Non-Consent Properties to the Company;
- Calpine's execution of all documents and performance of all tasks required under "further assurances" provisions of the Purchase Agreement with respect to certain of the oil and natural gas properties for which the Company has already paid Calpine; and

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- Resolution of the final amounts the Company is to pay Calpine, which the Company has concluded is approximately $79 million, consisting of roughly $68 million for the Non-Consent Properties and approximately $11 million in other true-up payment obligations.

At a hearing held on July 12, 2006, the Court in Calpine Corporation's bankruptcy took the following steps:

- In response to an objection filed by the Department of Justice and asserted by the California State Lands Commission that the Debtors' Motion to Assume Non-Residential Leases and Set Cure Amounts (the "Motion"), did not allow adequate time for an appropriate response, Calpine withdrew from the list of Oil and Gas Leases that were the subject of the Motion those leases issued by the United States (and managed by the Minerals Management Service of the United States Department of Interior) (the "MMS Oil and Gas Leases") and the State of California (and managed by the California State Lands Commission) (the "CSLC Leases"). Calpine and both the Department of Justice and the State of California agreed to an extension of the existing deadline to November 15, 2006 to assume or reject the MMS Oil and Gas Leases and CSLC Leases under Section 365 of the Bankruptcy Code, to the extent the MMS Oil and Gas Leases and CSLC Leases are leases subject to Section 365. The effect of these actions was to render the objection of the Company inapplicable at that time; and

- The Court also encouraged Calpine and the Company to arrive at a business solution to all remaining issues including approximately $68 million payable to Calpine for conveyance of the Non-Consent Properties.

On August 1, 2006, the Company filed a number of proofs of claim in the Calpine bankruptcy asserting claims against a variety of Calpine debtors seeking recovery of $27.9 million in liquidated amounts and unliquidated damages in amounts that can not presently be determined. The Company continues to undertake to work with Calpine on a cooperative and expedited basis toward resolution of unresolved conveyance of properties and post closing adjustments under the Purchase Agreement.

By a proposed stipulation dated October 18, 2006, Calpine and the Department of Justice agreed to further extend the deadline to assume or reject the MMS Oil and Gas Leases under Section 365 of the Bankruptcy Code from November 15, 2006 to January 31, 2007, to the extent the MMS Oil and Gas Leases are "unexpired leases" subject to Section 365. The Company has filed an objection to this proposed stipulation requesting the Court condition its approval of the proposed stipulation on inclusion of appropriate language adequately reserving the Company's rights with respect to the MMS Oil and Gas Leases and clarifying that the United States Department of Interior will not take regulatory action with respect to such leases without first seeking relief from the Court. On November 1, 2006, Calpine and the State of California submitted a similar proposed stipulation extending the deadline to assume or reject the CSLC Leases until January 31, 2007. The Company will take all necessary action to ensure its rights under the CSLC Leases are fully protected.

The Company continues to believe that it is unlikely that any challenges by the Calpine debtors or their creditors to the fairness of the Acquisition would be successful. However, there can be no assurance that Calpine, its creditors or interest holders may not challenge the fairness of some or all of the Acquisition. For a number of reasons, including the Company's understanding of the process that Calpine followed in allowing market forces to set the purchase price for the Acquisition, the Company believes that it is unlikely that any challenge to the fairness of the Acquisition would be successful.

Environmental

Environmental expenditures are expensed or capitalized, as appropriate, depending on their future economic benefit. Expenditures that relate to an existing condition caused by past operations, and that do not have future economic

benefit, are expensed. Liabilities related to future costs are recorded on an undiscounted basis when environmental assessments and/or remediation activities are probable and the cost can be reasonably estimated. The Company performed an environmental remediation study for two sites in California and correspondingly, recorded a liability, which at September 30, 2006 and December 31, 2005 was $0.1 million and $0.7 million, respectively. The Company does not expect that the outcome of our environmental matters discussed above will have a material adverse effect on the Company's financial position, results of operations or cash flows.

Participation in a Regional Carbon Sequestration Partnership

The Company has made preliminary preparations in connection with its participating in the United States Department of Energy's ("DOE") Regional Carbon Sequestration Partnership program ("WESTCARB") with the California Energy Commission and the University of California, Lawrence Berkeley Laboratory. The Company has been selected by the DOE for this project. Under WESTCARB, the Company would be required to drill a carbon injection well, recondition an idle well for use as an observation well and provide WESTCARB with certain proprietary well data and technical assistance related to the evaluation and injection of carbon

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dioxide into a suitable natural gas reservoir in the Sacramento Basin. The Company's maximum contribution to WESTCARB is $1.0 million and will be limited to 20% of the total contributions to the project. The Company will not have any obligation under the WESTCARB project until it has entered into an acceptable contract and the project has obtained proper and necessary local, state and federal regulatory approvals, land use authorizations and third party property rights. No accrual was recorded at September 30, 2006 as the study is still in the preliminary stage.

(11) Comprehensive Income

The Company's total comprehensive income (loss) is shown below. For the six months ended June 30, 2005, the Predecessor did not have transactions affecting comprehensive income.

	Three Months Ended September 30, 2006		Three Months Ended September 30, 2005 (In thousands)		Nine Months Ended September 30, 2006	
Accumulated other comprehensive loss - beginning of period		$ (11,852)		$ -		$ (50,731)
Net income	11,922		8,207		31,412	
Change in fair value of derivative hedging instruments	45,638		(109,392)		119,036	
Hedge settlements reclassed to income	(9,114)		2,221		(19,804)	
Tax provision related to hedges	(13,880)		40,725		(37,709)	
Total other comprehensive income (loss)	22,644	22,644	(66,446)	(66,446)	61,523	61,523
Comprehensive income	34,566		(58,239)		92,935	
Accumulated other comprehensive income (loss)		$ 10,792		$ (66,446)		$ 10,792

(12) Stock-Based Compensation

Adoption of SFAS-123R

On January 1, 2003, Calpine prospectively adopted the fair market value method of accounting for stock-based employee compensation pursuant to SFAS No. 123. Expense amounts included in the combined historical financial statements for the six months ended June 30, 2005 are based on stock based compensation granted to employees by Calpine. Stock options were granted at an option price equal to the quoted market price at the date of the grant or award.

In determining the Company’s accounting policies, the Company chose to apply the intrinsic value method pursuant to APB No. 25, “Stock Issued to Employees” (“APB No. 25”), effective July 1, 2005. Under APB No. 25, no compensation expense is recognized when the exercise price for options granted equals the fair value of the Company’s common stock on the date of the grant. Accordingly, the provisions of SFAS No. 123 permit the continued use of the method prescribed by APB No. 25 but require additional disclosures, including pro forma calculations of net income (loss) per share as if the fair value method of accounting prescribed by SFAS No. 123 had been applied.

Following is a summary of the Company’s net income and net income per share for the three months ended September 30, 2005 as reported and on a pro forma basis as if the fair value method prescribed by SFAS No. 123 had been applied.

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	Three Months Ended September 30, 2005 (In thousands)
Net income, as reported	$ 8,207
Deduct: stock-based employee compensation expense determined under the fair value method for all awards, net of related tax effects	(288)
Pro forma net income	$ 7,919
Net income per share:	
Basic, as reported	$ 0.16
Basic, pro forma	$ 0.16
Diluted, as reported	$ 0.16
Diluted, pro forma	$ 0.16

Effective January 1, 2006, the Company began accounting for stock-based compensation under SFAS No. 123R, whereby the Company records stock-based compensation expense based on the fair value of awards described below. Stock-based compensation expense recorded for all share-based payment arrangements for the three and nine months ended September 30, 2006 (Successor) was $1.0 million and $4.3 million, with a tax benefit of $0.4 million and $1.6 million, respectively. Stock-based compensation expense for the three months ended September 30, 2005 (Successor) was $1.7 million with a tax benefit of $0.7 million. For the six months ended June 30, 2005 (Predecessor), stock-based compensation expense recorded was $0.2 million with a tax benefit of $0.1 million. The remaining compensation expense associated with total unvested awards as of September 30, 2006 was $9.8 million.

Successor

2005 Long-Term Incentive Plan

In July 2005, the Board of Directors adopted the Rosetta 2005 Long-Term Incentive Plan whereby stock is granted to employees, officers and directors of the Company. The Plan allows for the grant of stock options, stock awards, restricted stock, restricted stock units, stock appreciation rights, performance awards and other incentive awards. Employees, non-employee directors and other service providers of the Company and its affiliates who, in the opinion of the Compensation Committee or another Committee of the Board of Directors (the “Committee”), are in a position to make a significant contribution to the success of the Company and the Company’s affiliates are eligible to participate in the Plan. The Plan provides for administration by the Committee, which determines the type and size of award and sets the terms, conditions, restrictions and limitations applicable to the award within the confines of the Plan’s terms. The maximum number of shares available for grant under the plan is 3,000,000 shares of common stock plus any shares of common stock that become available under the Plan for any reason other than exercise, such as shares traded for the related tax liabilities of employees. The maximum number of shares of common stock available for grant of awards under the Plan to any one participant is (i) 300,000 shares during any fiscal year in which the participant begins work for Rosetta and (ii) 200,000 shares during each fiscal year thereafter.

Stock Options

The Company has granted stock options under its 2005 Long-Term Incentive Plan. Options generally expire ten years from the date of grant. The exercise price of the options can not be less than the fair market value per share of the Company’s common stock on the grant date.

The weighted average fair value at date of grant for options granted during the nine months ended September 30, 2006 was $10.69 per share. The weighted average fair value at date of grant for options granted during the three months ended September 30, 2005 (Successor) was $9.53 per share and for the six months ended June 30, 2005 (Predecessor), the weighted average fair value at date of grant for options granted was $1.27 per share. The fair value of options granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

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	Successor Nine Months Ended September 30, 2006	Successor Three Months Ended September 30, 2005	Predecessor Six Months Ended June 30, 2005
Expected option term (years)	6.5	6.5	2.5
Expected volatility	56.65%	56.65%	58.00%
Expected dividend rate	0.00%	0.00%	0.00%
Risk free interest rate	4.33% - 5.15%	4.03% - 4.33%	3.62%

The Company has assumed an annual forfeiture rate of 5% for the awards granted in 2006 based on the Company's history for this type of award to various employee groups. Compensation expense is recognized ratably over the requisite service period and immediately for retirement-eligible employees.

The following table summarizes information related to outstanding and exercisable options held by the Company's employees at September 30, 2006:

	Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (In thousands)
Outstanding at the December 31, 2005	706,550	$ 16.28		
Granted	245,950	17.83		
Exercised	(32,000)	16.10		
Forfeited	(59,875)	16.38		
Outstanding at September 30, 2006	860,625	$ 16.73	9.00	$ 747
Options Exercisable at September 30, 2006	349,649	$ 16.29	8.87	$ 393

Stock-based compensation expense recorded for stock option awards for the three and nine months ended September 30, 2006 is $0.6 million and $2.1 million, respectively. There was no stock-based compensation expense for stock option awards for the three months ended September 30, 2005. Stock-based compensation expense recorded for stock option awards for the six months ended June 30, 2005 (Predecessor) is $0.2 million. Unrecognized expense as of September 30, 2006 for all outstanding stock options is $5.3 million and will be recognized over a weighted average period of 1.47 years.

The total intrinsic value of options exercised during the nine months ended September 30, 2006 was $0.1 million. For the six months ended June 30, 2005, the Predecessor did not have any options exercised. The fair value of awards vested for the nine months ended September 30, 2006 was $6.3 million.

Restricted Stock

The Company has granted stock under its 2005 Long-Term incentive Plan with a maximum contractual life of three years. The fair value of restricted stock grants is based on the value of the Company's common stock on the date of grant. Compensation expense is recognized ratably over the requisite service period. The Company also assumes an annual forfeiture rate of 5 % for these awards based on the Company's history for this type of award to various employee groups.

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The following table summarizes information concerning restricted stock held by the Company's employees at September 30, 2006:

	Shares	Weighted Average Grant Date Fair Value
Non-vested shares outstanding at December 31, 2005	581,900	$ 16.27
Granted	129,800	17.70
Vested	(344,975)	16.11
Forfeited	(35,125)	16.18
Non-vested shares outstanding at September 30, 2006	331,600	$ 17.00

The non-vested restricted stock outstanding at September 30, 2006 vests at a rate of 25% on the first anniversary of the date of grant, 25% on the second anniversary and 50% on the third anniversary. The restrictions on 270,000 shares lapsed on the day after the Company's effective date of its recently completed initial public offering in February 2006 and therefore vested in the first quarter of 2006.

Stock-based compensation expense recorded for restricted stock awards for the three and nine months ended September 30, 2006 was $0.4 million and $2.2 million, respectively, and $1.7 million for the three months ended September 30, 2005. Unrecognized expense as of September 30, 2006 for all outstanding restricted stock awards is $4.5 million and will be recognized over a weighted average period of 1.58 years.

Predecessor

Retirement Savings Plan

The Predecessor had a defined contribution savings plan, under Section 401(a) and 501(a) of the Internal Revenue Code, in which the Predecessor's employees were eligible to participate. The plan provided for tax deferred salary deductions and after-tax employee contributions. Employees were immediately eligible upon hire. Contributions included employee salary deferral contributions and employer profit-sharing contributions made entirely in cash of 4% of employees' salaries, with employer contributions capped at $8,400 per year for 2005. There were no employer profit-sharing contributions for the six months ended June 30, 2005.

2000 Employee Stock Purchase Plan

The Predecessor adopted the 2000 Employee Stock Purchase Plan ("ESPP") in May 2000. The Predecessor's eligible employees could, in the aggregate, purchase up to 28,000,000 shares of common stock at semi-annual intervals through periodic payroll deductions. Purchases were limited to either a maximum value of $25,000 per calendar year based on the IRS Code Section 423 limitation or limited to 2,400 shares per purchase interval. Shares were purchased on May 31 and November 30 of each year until termination of the plan on May 31, 2010. Under the ESPP, 36,817 shares were issued to Calpine's employees at a weighted average fair market value of $2.53 per share, for the six months ended June 30, 2005. The purchase price was 85% of the lower of (i) the fair market value of the common stock on the participant's entry date into the offering period, or (ii) the fair market value on the semi-annual purchase date. The purchase price discount was significant enough to cause the ESPP to be considered compensatory under SFAS No. 123. As a result, the ESPP was accounted for as stock-based compensation in accordance with SFAS No. 123 for the six months ended June 30, 2005. For the six months ended June 30, 2005, compensation expense of $0.2 million was recorded under the ESPP.

1996 Stock Incentive Plan

The Predecessor adopted the 1996 Stock Incentive Plan (“SIP”) in September 1996 in which certain of the Company’s employees were eligible to participate. The SIP succeeded the Predecessor’s previously adopted stock option program. Under the SIP, the option exercise price generally equaled the stock’s fair market value on date of grant. The SIP options generally vested ratably over four years and expired after 10 years. As of June 30, 2005, the amount of shares outstanding under the 1996 incentive plan were 754,284.

(13) Earnings Per Share

Basic earnings per share is computed by dividing income available to common stockholders by the weighted average number of shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if contracts to issue common stock and related stock options were exercised at the end of the period.

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The following is a calculation of basic and diluted weighted average shares outstanding:

	Successor Three Months Ended September 30, 2006	Successor Three Months Ended September 30, 2005	Successor Nine Months Ended September 30 2006	Predecessor Six Months Ended June 30, 2005
	(In thousands)			
Basic weighted average number of shares outstanding	50,282	50,000	50,211	50,000
Dilution effect of stock option and awards at the end of the period	144	160	173	160
Diluted weighted average number of shares outstanding	50,426	50,160	50,384	50,160
Stock awards and shares excluded from diluted earnings per share due to anti-dilutive effect	179	-	229	-

(14) Operating Segments

The Company has one reportable segment, oil and natural gas exploration and production, as determined in accordance with SFAS No. 131, “Disclosure About Segments of an Enterprise and Related Information”. See below for information by geographic location.

Geographic Area Information

The Company owns oil and natural gas interests in eight main geographic areas all within in the United States. Geographic revenue and property, plant and equipment information below for the three and nine months ended September 30, 2006, the three months ended September 30, 2005 and the six months ended June 30, 2005 are based on physical location of the assets at the end of each period.

	Successor Three Months Ended September 30, 2006 (1)	Successor Three Months Ended September 30, 2005 (1)	Successor Nine Months Ended September 30, 2006 (1)	Predecessor Six Months Ended June 30, 2005
Oil and Natural Gas Revenue	(In thousands)			
California	$ 18,820	$ 20,893	$ 54,921	$ 43,385
Lobo	21,009	18,888	50,090	26,474
Perdido	4,939	5,712	21,722	12,380
State Waters	1,750	2,964	7,039	2,345
Other Onshore	8,205	4,267	20,381	7,662