CALLON PETROLEUM CO
Form 10-Q
May 11, 2009

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended March 31, 2009 **Commission File Number 001-14039**

CALLON PETROLEUM COMPANY
(Exact name of registrant as specified in its charter)

Delaware	**64-0844345**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

200 North Canal Street
Natchez, Mississippi 39120
(Address of principal executive offices)(Zip code)
(601) 442-1601
(Registrant s telephone number, including area code)

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

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

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 o	Accelerated filer þ	Non-accelerated filer o	Smaller reporting company o
		(Do not check if a smaller reporting company)	

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

As of May 4, 2009, there were 21,676,067 shares of the Registrant s Common Stock, par value $0.01 per share, outstanding.

CALLON PETROLEUM COMPANY
TABLE OF CONTENTS

Table of Contents

Callon Petroleum Company
Consolidated Balance Sheets
(In thousands, except share data)

	March 31, 2009 (Unaudited)	December 31, 2008 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 651	$ 17,126
Accounts receivable	21,472	44,290
Fair market value of derivatives	14,857	21,780
Other current assets	191	1,103
Total current assets	37,171	84,299
Oil and gas properties, full-cost accounting method:		
Evaluated properties	1,587,795	1,581,698
Less accumulated depreciation, depletion and amortization	(1,464,687)	(1,455,275)
	123,108	126,423
Unevaluated properties excluded from amortization	28,595	32,829
Total oil and gas properties	151,703	159,252
Other property and equipment, net	2,419	2,536
Restricted investments	4,775	4,759
Investment in Medusa Spar LLC	12,183	12,577
Other assets, net	2,172	2,667
Total assets	$ 210,423	$ 266,090
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$ 23,375	$ 76,516
Asset retirement obligations	9,456	9,151
Total current liabilities	32,831	85,667
9.75% Senior Notes	195,065	194,420
Callon Entrada Credit Facility (non-recourse)	78,435	78,435
Total long-term debt	273,500	272,855

Asset retirement obligations	32,273	33,043
Callon Entrada Credit Facility interest payable (non-recourse)	3,339	2,719
Other long-term liabilities	1,638	1,610
Total liabilities	343,581	395,894
Stockholders equity:		
Preferred Stock, $.01 par value, 2,500,000 shares authorized;		
Common Stock, $.01 par value, 30,000,000 shares authorized; 21,637,470 and 21,621,142 shares outstanding at March 31, 2009 and December 31, 2008, respectively	216	216
Capital in excess of par value	228,968	227,803
Other comprehensive income	7,234	14,157
Retained (deficit) earnings	(369,576)	(371,980)
Total stockholders equity	(133,158)	(129,804)
Total liabilities and stockholders equity	$ 210,423	$ 266,090

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

Table of Contents

Callon Petroleum Company
Consolidated Statements of Operations
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended March 31,	
	2009	**2008**
Operating revenues:		
Oil sales	$ 15,952	$ 25,096
Gas sales	8,863	19,864
Total operating revenues	24,815	44,960
Operating expenses:		
Lease operating expenses	4,039	5,178
Depreciation, depletion and amortization	9,413	15,029
General and administrative	1,819	2,652
Accretion expense	1,038	1,032
Total operating expenses	16,309	23,891
Income from operations	8,506	21,069
Other (income) expenses:		
Interest expense	4,782	9,940
Callon Entrada Credit Facility interest expense (non-recourse)	1,556	
Other (income) expense	(95)	(472)
Total other (income) expenses	6,243	9,468
Income before income taxes	2,263	11,601
Income tax (benefit) expense	(24)	4,082
Income before equity in earnings of Medusa Spar LLC	2,287	7,519
Equity in earnings of Medusa Spar LLC, net of tax	117	113
Net income available to common shares	$ 2,404	$ 7,632
Net income per common share:		
Basic	$ 0.11	$ 0.37

Diluted	$ 0.11	$ 0.35
Shares used in computing net income per common share:		
Basic	21,607	20,871
Diluted	21,607	21,644

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

4

Table of Contents

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

	Three Months Ended March 31, 2009	March 31, 2008
Cash flows from operating activities:		
Net income	$ 2,404	$ 7,632
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation, depletion and amortization	9,629	15,213
Accretion expense	1,038	1,032
Amortization of deferred financing costs	731	873
Equity in earnings of Medusa Spar LLC	(117)	(113)
Deferred income tax expense	(24)	4,082
Non-cash charge related to compensation plans	569	371
Excess tax benefits from share-based payment arrangements		(47)
Changes in current assets and liabilities:		
Accounts receivable	5,761	(648)
Other current assets	912	4,702
Current liabilities	(19,614)	(252)
Change in gas balancing receivable	319	923
Change in gas balancing payable	30	557
Change in other long-term liabilities	618	(4)
Change in other assets, net	(10)	810
Cash provided by operating activities	2,246	35,131
Cash flows from investing activities:		
Capital expenditures	(19,295)	(46,208)
Distribution from Medusa Spar LLC	574	108
Cash used in investing activities	(18,721)	(46,100)
Cash flows from financing activities:		
Equity issued related to employee stock plans		(16)
Excess tax benefits from share-based payment arrangements		47
Cash provided by financing activities		31
Net decrease in cash and cash equivalents	(16,475)	(10,938)
Cash and cash equivalents:		
Balance, beginning of period	17,126	53,250

Balance, end of period	$ 651	$ 42,312

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

Table of Contents

CALLON PETROLEUM COMPANY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2009

1. General

The financial information presented as of any date other than December 31, 2008 has been prepared from the books and records of Callon Petroleum Company (the Company or Callon) without audit. Financial information as of December 31, 2008 has been derived from the audited financial statements of the Company, but does not include all disclosures required by U.S. generally accepted accounting principles. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, necessary for the fair presentation of the financial information for the periods indicated, have been included. For further information regarding the Company s accounting policies, refer to the Consolidated Financial Statements and related notes for the year ended December 31, 2008 included in the Company s Annual Report on Form 10-K filed March 19, 2009. The results of operations for the three-month period ended March 31, 2009 are not necessarily indicative of future financial results.

2. Net Income Per Share

Basic net income per share was computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted net income per common share was determined on a weighted average basis using common shares issued and outstanding adjusted for the effect of stock options and restricted stock considered common stock equivalents computed using the treasury stock method.

A reconciliation of the basic and diluted net income per share computation is as follows (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2009	2008
(a) Net income	$ 2,404	$ 7,632
(b) Weighted average shares outstanding	21,607	20,871
Dilutive impact of stock options		197
Dilutive impact of warrants		453
Dilutive impact of restricted stock		123
(c) Weighted average shares outstanding for diluted net income per share	21,607	21,644
Basic net income per share (a¸b)	$ 0.11	$ 0.37
Diluted net income per share (a¸c)	$ 0.11	$ 0.35
Shares excluded due to the exercise / grant price being greater than the average share price		
Stock options	503	30
Warrants	365	
Restricted Stock	509	

Table of Contents

3. Derivatives

The Company periodically uses derivative financial instruments to manage oil and gas price risk on a limited amount of its future production and does not use these instruments for trading purposes. Settlements of oil and gas derivative contracts are generally based on the difference between the contract price or prices specified in the derivative instrument and a NYMEX price or other cash or futures index price. Such derivative contracts are accounted for under Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, (SFAS 133) as amended.

The Company s derivative contracts that are accounted for as cash flow hedges under SFAS 133 are recorded at fair market value and the changes in fair value are recorded through other comprehensive income (loss), net of tax, in stockholders equity. The cash settlements on contracts for future production are recorded as an increase or decrease in oil and gas sales. The changes in fair value related to ineffective derivative contracts are recognized as derivative expense (income). The cash settlements on these contracts are also recorded within derivative expense (income).

Cash settlements on effective oil and gas cash flow hedges during the three-month period ended March 31, 2009 resulted in an increase in oil and gas sales of $7.9 million. For the three-month period ended March 31, 2008 cash settlements on effective oil and gas cash flow hedges resulted in a decrease in oil and gas sales of $1.8 million.

The Company s derivative contracts are carried at fair value on our consolidated balance sheet under the caption Fair Market Value of Derivatives . The oil and gas derivative contracts are settled based upon reported prices on NYMEX. The estimated fair value of these contracts is based upon closing exchange prices on NYMEX and in the case of collars and floors, the time value of options. See Note 8, Fair Value Measurements.

Listed in the table below are the outstanding oil and gas derivative contracts as of March 31, 2009:

Collars

Product	Volumes per Month	Quantity Type	Average Floor Price	Average Ceiling Price	Period
Oil	30,000	Bbls	$110.00	$175.75	04/09-12/09

Table of Contents

4. Long-Term Debt

Long-term debt consisted of the following at:

	March 31, 2009	December 31, 2008
	(In thousands)	
Senior Secured Credit Facility (UBOC) (matures September 25, 2012)	$	$
9.75% Senior Notes (due 2010), net of discount	195,065	194,420
Callon Entrada Credit Facility (non-recourse)	78,435	78,435
Total long-term debt	$ 273,500	$ 272,855

On September 25, 2008, the Company completed a $250 million second amended and restated senior secured credit agreement, which matures on September 25, 2012, with the Union Bank of California N.A. (UBOC) as administrative agent and issuing lender. On March 19, 2009, the Company entered into the first amendment of the Second Amended and Restated Credit Agreement which states that a default under the Callon Entrada non-recourse loan (described below) would not constitute a default under the Company s senior secured revolving credit facility. The amendment set the borrowing base at $48 million and implemented a Monthly Commitment Reduction (MCR) commencing on June 1, 2009 in the amount of $4.33 million per month. The borrowing base and MCR are both subject to re-determination August 1, 2009 and quarterly thereafter. Borrowings under the credit agreement are secured by mortgages covering the Company s major fields excluding Entrada. As of March 31, 2009, there were no borrowings under the agreement; however Callon had a letter of credit outstanding in the amount of $15 million to secure the drilling rig, Ocean Victory, for the development of Entrada. As a result, $33 million was available for future borrowings under the credit agreement as of March 31, 2009.

Subsequent to March 31, 2009, Diamond Offshore Drilling, Inc. (Diamond) called on the outstanding letter of credit for CIECO Energy (US) Limited s (CIECO) share of the settlement for the termination of the Ocean Victory drilling contract in the amount of $7.3 million. Callon paid its share, in the amount of $7.3 million, in March 2009. The remaining balance of the letter of credit was cancelled on April 2, 2009 by Diamond. As a result of these transactions, $40.7 million was available for future borrowings as of April 2, 2009. The Company continues to discuss with CIECO its failure to fund the settlement for the termination of the drilling contract. The $7.3 million due from CIECO for their share of the settlement for the termination of the drilling contract is included in accounts receivable at March 31, 2009.

A wholly-owned subsidiary of Callon, Callon Entrada Company (Callon Entrada), entered into a credit agreement with CIECO Energy (Entrada) LLC, (CIECO Entrada) pursuant to which Callon Entrada may borrow up to $150 million, plus interest expense incurred of up to $12 million, to finance the development of the Entrada project. The agreement bears interest at six-month LIBOR (as in effect on the first day of each interest period) plus 375 basis points and is subject to customary representations, warranties, covenants and events of default. As of March 31, 2009, $78.4 million of principal and $3.3 million of interest was outstanding under this facility.
The Callon Entrada credit facility is fully collateralized by the Entrada Field. Callon and its subsidiaries (other than Callon Entrada) did not guarantee and are not otherwise obligated to

8

Table of Contents

repay the principal, accrued interest or any other amount which may become outstanding under the Callon Entrada credit facility. However, Callon has entered into a customary indemnification agreement pursuant to which it agrees to indemnify the lenders under the Callon Entrada credit facility against Callon Entrada s misappropriation of funds, non-performance of certain covenants and similar matters. In addition, Callon also guaranteed the obligations of Callon Entrada to fund its proportionate share of any operating costs related to the Entrada project that Callon Entrada may, from time to time, expressly approve under the Entrada joint operating agreement. Callon also has guaranteed Callon Entrada s payment of all amounts to plug and abandon wells and related facilities for a breach of law, rule or regulation (including environmental laws) and for any losses attributable to gross negligence of Callon Entrada. As of March 31, 2009, the wind down of the Entrada project was substantially complete and most of the costs had been paid. The sale of equipment purchased for the Entrada project but not used is in progress and as of March 2009, the Company had sold $934,000 of equipment net to its interest, which was applied to unpaid interest expense under the credit facility.

On April 8, 2008, we completed the sale of a 50% working interest in the Entrada Field to CIECO for a purchase price of $175 million with a cash payment of $155 million at closing and the additional $20 million payable after the achievement of certain production milestones. Simultaneously with the closing of the CIECO transaction, the Company used the proceeds from the sale, cash on hand and a draw of $16 million from the UBOC credit agreement, to extinguish the $200 million senior secured revolving credit agreement, which was secured by a lien on the Entrada properties. Due to the early extinguishment of the $200 million senior revolving credit facility on April 8, 2008, Callon incurred expenses of $11.9 million consisting of $6.3 million in cash pre-payment penalties plus a non-cash charge of $5.6 million related to the amortization expense associated with the deferred financing costs related to the credit facility. This facility was secured by a lien on the Entrada properties.

On April 2, 2009, Callon Entrada received a notice from CIECO advising Callon Entrada that certain events of default occurred under the non-recourse credit agreement relating to failure to pay interest when due and the breach of various other covenants related to the decision to abandon the Entrada project. However, the Company has not classified any of this facility as current and has not included any amounts due in the five year maturities as it believes, based on the advice of counsel, that the Callon Entrada credit agreement does not obligate Callon or any of its subsidiaries (other than Callon Entrada) to pay principal, accrued interest or other amounts which may be owed under such credit agreement. In addition, Callon Entrada has no assets to pay the debt except for the sales proceeds from equipment that was purchased for the Entrada project but not used.

Prior to abandonment of the Entrada project, CIECO failed to fund two loan requests totaling $40 million under the non-recourse credit agreement. These loan requests were to cover Callon Entrada s share of the cost incurred to develop the Entrada field up to the suspension of the project. The Company continues to discuss with CIECO its failure to fund the $40 million in loan requests. Because these discussions are in early stages, no assurances can be made regarding the outcome of discussions. The Company does not believe that we have waived any of our rights under the agreements with CIECO.

Table of Contents

5. Comprehensive Income

A summary of the Company s comprehensive income is detailed below (in thousands, net of tax):

	Three Months Ended March 31,	
	2009	2008
Net income	$ 2,404	$ 7,632
Other comprehensive income:		
Change in fair value of derivatives	(6,923)	(2,215)
Total comprehensive income	$ (4,519)	$ 5,417

6. Income Taxes

Below is an analysis of deferred income taxes as of March 31, 2009 and December 31, 2008.

	March 31, 2009	December 31, 2008
	(In thousands)	
Deferred tax asset:		
Federal net operating loss carryforwards	$ 70,481	$ 68,432
State net operating loss carryforwards	47,318	45,939
Statutory depletion carryforwards	4,568	4,561
Alternative minimum tax credit carryforward	375	375
Asset retirement obligations	12,934	13,102
Oil and gas properties	54,846	58,061
Other	2,665	2,241
Valuation allowance	(176,978)	(174,062)
Total deferred tax asset	16,209	18,649
Deferred tax liability:		
Other	16,209	18,649
Total deferred tax liability	16,209	18,649
Net deferred tax asset	$	$

The Company follows the asset and liability method of accounting for deferred income taxes prescribed by Statement of Financial Accounting Standards No. 109 (SFAS 109) Accounting for Income Taxes . The statement provides for the recognition of a deferred tax asset for deductible temporary timing differences, capital and operating loss carryforwards, statutory depletion carryforward and tax credit carryforwards, net of a valuation allowance . The valuation allowance is provided for that portion of the asset, for which it is deemed more likely than not, that it, will not be realized.

Table of Contents

As discussed in Notes 5 of the Consolidated Financial Statements for the year ended December 31, 2008 included in the Company s Annual Report on Form 10-K filed March 19, 2009, the Company established a valuation allowance of $174 million as of December 31, 2008. The Company revised the valuation allowance in the first quarter of 2009 as a result of current year ordinary income, the impact of which is included in the Company s effective tax rate.

7. Asset Retirement Obligations

The following table summarizes the activity for the Company s asset retirement obligations:

		Three Months Ended March 31, 2009
Asset retirement obligations at beginning of period	$	42,194
Accretion expense		1,038
Liabilities incurred		
Liabilities settled		(1,181)
Revisions to estimate		(322)
Asset retirement obligations at end of period		41,729
Less: current asset retirement obligations		(9,456)
Long-term asset retirement obligations	$	32,273

Assets, primarily U.S. Government securities, of approximately $4.8 million at March 31, 2009, are recorded as restricted investments. These assets are held in abandonment trusts dedicated to pay future abandonment costs for several of the Company s oil and gas properties.

8. Fair Value Measurements

Statement of Financial Accounting Standards No. 157, (SFAS 157), Fair Value Measurements defines fair value, establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements. SFAS 157 establishes a fair value hierarchy which consists of three broad levels that prioritize the inputs to valuation techniques used to measure fair value.

Level 1 valuations consist of unadjusted quoted prices in active markets for identical assets and liabilities and have the highest priority.

Level 2 valuations rely on quoted market information for the calculation of fair market value.

Level 3 valuations are internal estimates and have the lowest priority.

Per SFAS 157, the Company has classified its derivatives into these levels depending upon the data relied on to determine the fair values of the derivative instruments. The fair values of collars and natural gas basis swaps are estimated using internal discounted cash flow calculations based upon forward commodity price curves or quotes obtained from

Table of Contents

counterparties to the agreements and are designated as Level 3. The following table summarizes the valuation of our assets and liabilities measured at fair value on a recurring basis at March 31, 2009 (in thousands):