

CONTANGO OIL & GAS CO
Form 10-Q
February 09, 2007

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 December 31, 2006

OR

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

For the transition period from _____ to _____

Commission file number 001-16317

CONTANGO OIL & GAS COMPANY

(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of

incorporation or organization)

3700 BUFFALO SPEEDWAY, SUITE 960

HOUSTON, TEXAS 77098

95-4079863
(IRS Employer

Identification No.)

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(Address of principal executive offices)

(713) 960-1901

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one). Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

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

The total number of shares of common stock, par value \$0.04 per share, outstanding as of February 4, 2007 was 15,882,807.

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE SIX MONTHS ENDED DECEMBER 31, 2006

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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.

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

ASSETS

	December 31, 2006 (Unaudited)	June 30, 2006
CURRENT ASSETS:		
Cash and cash equivalents	\$ 8,435,386	\$ 10,274,950
Short-term investments	100,297	18,472,327
Inventory tubulars	334,797	194,825
Accounts Receivable:		
Trade receivables	682,141	481,593
Advances to affiliates	2,078,810	256,180
Joint interest billings receivable	1,651,665	3,422,261
Prepaid capital costs	2,800,713	1,208,299
Other	311,683	202,583
Total current assets	16,395,492	34,513,018
PROPERTY AND EQUIPMENT:		
Natural gas and oil properties, successful efforts method of accounting:		
Proved properties	36,958,532	18,395,015
Unproved properties	26,943,013	23,293,300
Furniture and equipment	231,877	231,877
Accumulated depreciation, depletion and amortization	(1,061,101)	(662,877)
Total property and equipment, net	63,072,321	41,257,315
OTHER ASSETS:		
Cash and other assets held by affiliates	1,985,554	1,054,100
Investment in Freeport LNG Project	3,243,585	3,243,585
Investment in Contango Venture Capital Corporation	5,150,393	4,453,028
Deferred income tax asset	5,739,619	4,455,190
Facility fees and other assets	335,505	408,769
Total other assets	16,454,656	13,614,672
TOTAL ASSETS	\$ 95,922,469	\$ 89,385,005

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

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

LIABILITIES AND SHAREHOLDERS' EQUITY

	December 31, 2006 (Unaudited)	June 30, 2006
CURRENT LIABILITIES:		
Accounts payable	\$ 3,216,391	\$ 1,041,505
Joint interest advances		5,638,600
Accrued exploration and development	8,118,033	8,278,245
Advances from affiliates	1,181,421	194,862
Debt of affiliates	2,135,023	
Other accrued liabilities	846,698	1,026,743
 Total current liabilities	 15,497,566	 16,179,955
 LONG-TERM DEBT	 20,000,000	 10,000,000
 ASSET RETIREMENT OBLIGATION	 401,458	 665,458
SHAREHOLDERS' EQUITY:		
Convertible preferred stock, 6%, Series D, \$0.04 par value, 4,000 shares authorized, 1,900 and 2,000 shares issued and outstanding, liquidation preference of \$9,500,000 and \$10,000,000 at \$5,000 per share, as of December 31, 2006 and June 30, 2006, respectively	76	80
Common stock, \$0.04 par value, 50,000,000 shares authorized, 17,645,643 shares issued and 15,070,643 outstanding at December 31, 2006, 17,574,085 shares issued and 14,999,085 outstanding at June 30, 2006,	705,824	702,961
Additional paid-in capital	45,451,715	45,105,504
Treasury stock at cost (2,575,000 shares)	(6,180,000)	(6,180,000)
Retained earnings	20,045,830	22,911,047
 Total shareholders' equity	 60,023,445	 62,539,592
 TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	 \$ 95,922,469	 \$ 89,385,005

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

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2006	2005	2006	2005
REVENUES:				
Natural gas and oil sales	\$ 850,407	\$ 44,298	\$ 2,042,713	\$ 192,078
Total revenues	850,407	44,298	2,042,713	192,078
EXPENSES:				
Operating expenses	144,702	125,896	277,651	131,646
Exploration expenses	496,123	377,708	897,470	717,146
Depreciation, depletion and amortization	292,192	31,763	504,383	87,123
Impairment of natural gas and oil properties	192,109		192,109	
General and administrative expenses	1,425,599	1,099,711	2,528,941	2,021,974
Total expenses	2,550,725	1,635,078	4,400,554	2,957,889
LOSS FROM CONTINUING OPERATIONS BEFORE OTHER INCOME AND INCOME TAXES	(1,700,318)	(1,590,780)	(2,357,841)	(2,765,811)
OTHER INCOME (EXPENSE):				
Interest expense (net of interest capitalized)	(390,434)	(96)	(557,905)	(192)
Interest income	155,483	190,315	407,142	399,368
Gain (loss) on sale of assets and other	(1,401,076)	32,164	(1,316,685)	241,686
LOSS FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	(3,336,345)	(1,368,397)	(3,825,289)	(2,124,949)
Benefit for income taxes	1,019,484	535,585	1,252,572	814,995
LOSS FROM CONTINUING OPERATIONS	(2,316,861)	(832,812)	(2,572,717)	(1,309,954)
DISCONTINUED OPERATIONS (Note 4)				
Discontinued operations, net of income taxes		614,425		1,302,868
NET LOSS	(2,316,861)	(218,387)	(2,572,717)	(7,086)
Preferred stock dividends	142,500	150,000	292,500	301,000
NET LOSS ATTRIBUTABLE TO COMMON STOCK	\$ (2,459,361)	\$ (368,387)	\$ (2,865,217)	\$ (308,086)
NET INCOME (LOSS) PER SHARE:				
Basic				
Continuing operations	\$ (0.16)	\$ (0.07)	\$ (0.19)	\$ (0.11)
Discontinued operations		0.04		0.09
Total	\$ (0.16)	\$ (0.03)	\$ (0.19)	\$ (0.02)
Diluted				
Continuing operations	\$ (0.16)	\$ (0.07)	\$ (0.19)	\$ (0.11)
Discontinued operations		0.04		0.09

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Total	\$	(0.16)	\$	(0.03)	\$	(0.19)	\$	(0.02)
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WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:

Basic	15,031,697	14,717,570	15,018,305	14,586,862
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Diluted	15,031,697	14,717,570	15,018,305	14,586,862
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The accompanying notes are an integral part of these consolidated financial statements.

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six Months Ended	
	December 31,	
	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Loss from continuing operations	\$ (2,572,717)	\$ (1,309,954)
Plus income from discontinued operations, net of income taxes		1,302,868
Net loss	(2,572,717)	(7,086)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation, depletion and amortization	504,383	673,857
Impairment of natural gas and oil properties	192,109	
Exploration expenditures	586,583	1,667,126
Deferred income taxes	(1,284,430)	828,558
Tax benefit from exercise of stock option	(31,857)	
Stock-based compensation	448,423	370,367
Loss (gain) on sale of assets and other	1,414,049	(7,276)
Changes in operating assets and liabilities:		
Decrease (increase) in accounts receivable and other	(200,548)	111,599
Increase in notes receivable	(525,000)	
Increase in prepaid insurance	(133,244)	(95,959)
Increase in interest receivable	(34,225)	
Increase in inventory	(139,972)	
Decrease in accounts payable	(3,463,714)	(148,563)
Increase (decrease) in other accrued liabilities	(183,658)	222,754
Increase (decrease) in income taxes payable	31,857	(1,658,548)
Other	(97,365)	(41,594)
Net cash provided by (used in) operating activities	(5,489,326)	1,915,235
CASH FLOWS FROM INVESTING ACTIVITIES:		
Natural gas and oil exploration and development expenditures	(31,910,638)	(9,028,243)
Increase in net investment in affiliates	(931,454)	(512,058)
Investment in Freeport LNG Project		(170,000)
Sale of short-term investments, net	18,372,030	13,686,413
Additions to furniture and equipment	(23,345)	(18,370)
Sale of assets	7,000,000	
(Increase) decrease in advances to operators		592,170
Investment in Contango Venture Capital Corporation	(600,000)	(456,023)
Acquisition of overriding royalty interests		(1,000,000)
Acquisition of Republic Exploration LLC and Contango Offshore Exploration interests		(7,500,000)
Net cash used in investing activities	(8,093,407)	(4,406,111)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings under credit facility	10,000,000	
Borrowings by affiliates	2,135,023	
Proceeds from preferred equity issuances		10,000,000
Preferred stock dividends	(292,500)	(301,000)
Repurchase/cancellation of stock options	(181,540)	

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Tax benefit from cancellation of stock option	31,856	
Proceeds from exercised options, warrants and others	50,330	389,036
Preferred equity issuance costs		(383,562)
Net cash provided by financing activities	11,743,169	9,704,474
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(1,839,564)	7,213,598
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	10,274,950	3,985,775
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 8,435,386	\$ 11,199,373
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for taxes	\$	\$ 710,000
Cash paid for interest	\$ 710,395	\$ 192

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

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

(Unaudited)

For the Six Months Ended December 31, 2006

	Preferred Stock		Common Stock		Paid-in Capital	Treasury Stock	Retained Earnings	Total Shareholders Equity
	Shares	Amount	Shares	Amount				
Balance at June 30, 2006	2,000	\$ 80	14,999,085	\$ 702,961	\$ 45,105,504	\$ (6,180,000)	\$ 22,911,047	\$ 62,539,592
Issuance of common stock			16,750	670	81,268			81,938
Expense of stock options					147,222			147,222
Repurchase/cancellation of stock options, net of tax benefit					(152,508)			(152,508)
Net loss							(255,856)	(255,856)
Preferred stock dividends							(150,000)	(150,000)
Balance at September 30, 2006	2,000	80	15,015,835	703,631	45,181,486	(6,180,000)	22,505,191	62,210,388
Conversion of Series D preferred shares	(100)	(4)	41,666	1,667	(1,663)			
Exercise of stock options			4,000	160	50,170			50,330
Tax benefit from exercise of stock options					2,825			2,825
Issuance of common stock			8,416	337	71,704			72,041
Cashless exercise of stock options			726	29	(29)			
Expense of stock options					147,222			147,222
Net loss							(2,316,861)	(2,316,861)
Preferred stock dividends							(142,500)	(142,500)
Balance at December 31, 2006	1,900	\$ 76	15,070,643	\$ 705,824	\$ 45,451,715	\$ (6,180,000)	\$ 20,045,830	\$ 60,023,445

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

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The accompanying unaudited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America for interim financial information, pursuant to the rules and regulations of the Securities and Exchange Commission, including instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete annual financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All such adjustments are of a normal recurring nature. Certain prior year amounts have been reclassified to conform to the current year presentation. The financial statements should be read in conjunction with the audited financial statements and notes included in the Company's Form 10-K for the fiscal year ended June 30, 2006. The results of operations for the three and six months ended December 31, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2007.

1. Summary of Significant Accounting Policies

The application of generally accepted accounting principles involves certain assumptions, judgments, choices and estimates that affect reported amounts of assets, liabilities, revenues and expenses. Thus, the application of these principles can result in varying results from company to company. Contango's critical accounting policies, which are described below, relate to the successful efforts method of accounting for costs related to natural gas and oil activities, consolidation principles and stock based compensation, cash and cash equivalents, and short-term investments.

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 cost center by cost center basis using the unit of production method, with lease acquisition costs amortized over total proved reserves and other costs amortized over proved developed reserves.

When circumstances indicate that proved properties may be impaired, the Company compares expected undiscounted future net cash flows on a cost center basis to the unamortized capitalized cost of the asset. If the future undiscounted net cash flows, based on the Company's estimate of future natural gas and oil prices and operating costs and anticipated production from proved reserves, are lower than the unamortized capitalized cost, then the capitalized cost is reduced to fair market value. Approximately \$0.2 million of impairment was reported for the six and three months ended December 31, 2006 which was attributable to a write-down of costs relating to the Alta-Ellis #1 well in December 2006.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 144 (SFAS 144), Accounting for the Impairment or Disposal of Long-Lived Assets, the Company classified its \$11.6 million property sale effective April 1, 2006, and its \$2.0 million property sale effective February 1, 2006, as discontinued operations. An integral and on-going part of our business strategy is to sell our proved reserves from time to time in order to generate additional capital to reinvest in our onshore and offshore exploration programs. Thus, it is our intent to remain an independent natural gas and oil company engaged in the exploration, production, and acquisition of natural gas and oil.

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Cash Equivalents. Cash equivalents are considered to be highly liquid investment grade debt investments having an original maturity of 90 days or less. As of December 31, 2006, the Company had \$8,435,386 in cash and cash equivalents, of which \$6,826,193 was invested in highly liquid AAA-rated tax-exempt money market funds.

Short Term Investments. As of December 31, 2006, the Company had \$100,297 invested in a portfolio of periodic auction reset (PAR) securities, which have coupons that periodically reset to market interest rates at intervals ranging from 7 to 35 days. These PAR securities are being classified as short term investments and consist of AAA-rated tax-exempt municipal bonds. PAR securities are highly liquid and have minimal interest rate risk.

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 subsidiaries not wholly owned, such as 42.7% owned Republic Exploration LLC (REX), 50% owned Magnolia Offshore Exploration LLC (MOE), and 76.0% owned Contango Offshore Exploration LLC (COE) are not controlled by the Company and are proportionately consolidated. By agreement, REX, MOE and COE have disproportionate allocations of their profits and losses among the owners. Accordingly, the Company determines its income or losses from the ventures based on a hypothetical liquidation determination of how increases or decreases in the book value of the ventures' net assets will ultimately affect the cash payments to the Company in the event of dissolution.

By agreement, since the Company was the only owner that contributed cash to REX, MOE and COE upon formation of these three ventures, the Company consolidated 100% of the ventures' net assets and results of operations until the ventures expended all of the Company's initial cash contributions. Subsequent to that event, the owners' shares in the net assets of the ventures are based on their stated ownership percentages. By agreement, the owners in COE have immediately shared in the net assets of COE, including the Company's initial cash contribution, based on their stated ownership percentages. The other owners of REX, MOE and COE who participated in the initial formation of these entities contributed seismic data and related geological and geophysical services to the ventures in exchange for ownership interests.

On September 2, 2005, the Company purchased an additional 9.4% ownership interest in each of REX and COE. Both interests were purchased from an existing owner, which prior to the sale, owned 33.3% of each of the two subsidiaries. As a result of these two purchases, the Company's equity ownership interest in REX has increased from 33.3% to 42.7% and in COE from 66.6% to 76.0%. On September 2, 2005, an independent third party also purchased a 9.4% interest in each of REX and COE from the same selling owner whose ownership interest thus decreased from 33.3% to 14.6% in each such entity.

Contango's 10% limited partnership interest in Freeport LNG Development, L.P. (Freeport LNG) is accounted for at cost. As a 10% limited partner, the Company has no ability to direct or control the operations or management of the general partner.

Contango's 32% ownership in Contango Capital Partnership Management, LLC (CCPM), Contango's 25% limited partnership interest in Contango Capital Partners, L.P. (CCPLP) and Contango's 33% ownership of Mobilize Inc. (Mobilize) are accounted for using the equity method. Under the equity method, only Contango's investment in and amounts due to and from the equity investee are included in the consolidated balance sheet. CCPLP formed the Contango Capital Partners Fund, LP (the Fund) in January 2005. The Fund owns equity interests in a portfolio of alternative energy companies. The Fund marks these equity interests to market according to fair market values on a quarterly basis.

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

Recent Accounting Pronouncements. In September 2006, the Securities and Exchange Commission staff issued Staff Accounting Bulletin (SAB) No. 108, incorporated into the SEC Rules and Regulations as Section N to Topic 1, Financial Statements, which provides guidance concerning the effects of prior year misstatements in

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

quantifying current year misstatements for the purpose of materiality assessments. Specifically, entities must consider the effects of prior year unadjusted misstatements when determining whether a current year misstatement will be considered material to the financial statements at the current reporting period and record the adjustment, if deemed material. SAB No. 108 becomes effective for the first fiscal year ending after November 15, 2006, with adoption in the first interim period of that year encouraged. Upon adoption, entities may either restate the financial statements for each period presented or record the cumulative effect of the error correction as an adjustment to the opening balance of retained earnings at the beginning of the period of adoption, and provide disclosure of each individual error being corrected within the cumulative adjustment, stating when and how each error arose and the fact that the error was previously considered immaterial. We do not expect this authoritative guidance to have a material impact on our financial position, results of operations and cash flows.

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value under Generally Accepted Accounting Principles and requires enhanced disclosures about fair value measurements. It does not require any new fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. SFAS No. 157 will not have a material impact on the Company.

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. It prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the provisions of FIN 48 and assessing the impact, if any, it may have on our financial position and results of operations.

Stock-Based Compensation. Effective July 1, 2001, the Company adopted the fair value based method prescribed in SFAS No. 123, Accounting for Stock Based Compensation. Under the fair value based 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 as of the date of grant using the Black-Scholes options-pricing model. Effective July 1, 2005, the Company adopted SFAS No. 123 (revised 2004) (SFAS 123(R)), Share-Based Payment. Prior to the adoption of SFAS 123(R), the Company presented all benefits from the exercise of share-based compensation as operating cash flows in the statement of cash flows. SFAS 123(R) requires the benefits of tax deductions in excess of the compensation cost recognized for the options (excess tax benefit) to be classified as financing cash flows. The fair value of each option is estimated as of the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants during the quarters ended December 31, 2005: (i) risk-free interest rate of 4.33 percent; (ii) expected lives of five years; (iii) expected volatility of 40 percent and (iv) expected dividend yield of zero percent. The Company had no stock option grants for the three months ended December 31, 2006.

Under the Company's 1999 Stock Incentive Plan, as amended (the 1999 Plan), the Company's Board of Directors may also grant restricted stock awards to officers or other employees of the Company. Restricted stock awards made under the 1999 Plan are subject to such restrictions, terms and conditions, including forfeitures, if any, as may be determined by the Board. Restricted stock awards generally vest over a period of three years. Grants of service based restricted stock awards are valued at our common stock price at the date of grant. During the six months ended December 31, 2006, the Company granted 16,750 shares of restricted stock to its employees, and 8,416 shares of restricted stock to its Board of Directors as part of its annual compensation. The shares of restricted stock granted to the Board of Directors vest over a period of one year.

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

During the six months ended December 31, 2006 and 2005, the Company recorded stock-based compensation charges of \$448,423 and \$370,367 to general and administrative expense, respectively.

2. Natural Gas and Oil Exploration 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 financial statements in conformity with generally accepted accounting principles 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.

3. Sale of Properties Continuing Operations

In December 2006, Contango Operators, Inc. (COI), a wholly-owned subsidiary of the Company, completed the sale of its 25% working interest in the Grand Isle 72 well (Liberty) to an independent oil and gas company for \$7.0 million. The sold property had reserves of approximately 1.9 billion cubic feet equivalent (Bcfe), net to COI. The Company recognized a loss of approximately \$1.4 million in December 2006 as a result of this sale. The Company continues to have an interest in Grand Isle 72 via its investment in COE.

4. Sale of Properties Discontinued Operations

On March 24, 2006, the Company's Board of Directors approved the sale of all of the Company's onshore producing assets in Texas and Alabama for an aggregate purchase price of \$11.6 million. These properties were held by Contango STEP, L.P. (STEP), an indirect wholly-owned subsidiary of the Company. The sale was completed in June 2006 pursuant to a purchase and sale agreement. The sold properties had net reserves of approximately 203 thousand barrels of oil and 849 million cubic feet (MMcf) of gas, or 2.1 Bcfe. The Company recognized a pre-tax gain of \$6.2 million for the year ended June 30, 2006. This sale has been classified as discontinued operations in our financial statements for all periods presented.

In March 2006, the Company completed the sale of its interest in a producing well in Zapata County, Texas to an independent oil and gas company for approximately \$2.0 million. Approximately 227 MMcf of proven reserves were sold. Pre-tax proceeds after netting adjustments were \$2.0 million. The Company recognized a pre-tax gain on sale of \$1.0 million for the year ended June 30, 2006. This sale has been classified as discontinued operations in our financial statements for all periods presented.

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company did not have any discontinued operations for the three or six months ended December 31, 2006. The summarized financial results for discontinued operations for the periods ended December 31, 2005 are as follows:

Operating Results :

	Three months ended December 31,		Six months ended December 31,	
	2006	2005	2006	2005
Revenues	\$	\$ 1,779,111	\$	\$ 2,821,882
Operating (expenses) credits		733,833*		948,332*
Exploration expenses		(1,202,665)		(1,202,665)
Depreciation, depletion and amortization		(365,010)		(586,734)
Gain on sale of discontinued operations				23,598
Gain before income taxes	\$	\$ 945,269	\$	\$ 2,004,413
Provision for income taxes		(330,844)		(701,545)
Gain from discontinued operations, net of income taxes	\$	\$ 614,425	\$	\$ 1,302,868

* Credits due to severance tax refunds

For the three and six months ended December 31, 2005, operating expenses from discontinued operations resulted in a net credit of \$733,833 and \$948,332, respectively, which was attributable to a credit for previously paid severance taxes. The Railroad Commission of Texas allows for a severance tax reduction on tight sand gas wells. As a result, some of our properties sold in fiscal year 2005 were eligible for severance tax reduction. By contractual agreement, revenues and expenses prior to July 1, 2004, the effective date of the sale, accrue to us.

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. Net Loss Per Common Share

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

	Three Months Ended			Three Months Ended		
	December 31, 2006			December 31, 2005		
	Loss	Weighted Average Shares	Per Share	Loss	Weighted Average Shares	Per Share
Loss from continuing operations including preferred dividends	\$ (2,459,361)	15,031,697	\$ (0.16)			