CONTANGO OIL & GAS CO
Form 10-Q
November 09, 2010
Table of Contents

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, 2010

OR

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

For the transition period from to

Commission file number 001-16317

CONTANGO OIL & GAS COMPANY

(Exact name of registrant as specified in its charter)

DELAWARE	**95-4079863**
(State or other jurisdiction of	**(IRS Employer**
incorporation or organization)	**Identification No.)**

3700 BUFFALO SPEEDWAY, SUITE 960

HOUSTON, TEXAS 77098

(Address of principal executive offices)

(713) 960-1901

(Registrant s telephone number, including area code)

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

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

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

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

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

The total number of shares of common stock, par value $0.04 per share, outstanding as of October 31, 2010 was 15,664,666.

Table of Contents

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2010

TABLE OF CONTENTS

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.

Table of Contents

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited)

ASSETS

	September 30, 2010	June 30, 2010
CURRENT ASSETS:		
Cash and cash equivalents	$ 63,737,221	$ 52,469,144
Accounts receivable:		
Trade receivables	43,321,739	41,938,567
Joint interest billings	13,399,617	11,758,980
Income taxes	4,266,617	5,410,577
Other receivable	3,169,392	3,164,604
Notes receivable	2,027,590	2,027,590
Other	2,205,526	3,103,927
Total current assets	132,127,702	119,873,389
PROPERTY, PLANT AND EQUIPMENT:		
Natural gas and oil properties, successful efforts method of accounting:		
Proved properties	545,767,540	540,215,841
Unproved properties	13,059,621	10,825,074
Furniture and equipment	284,706	276,817
Accumulated depreciation, depletion and amortization	(94,112,935)	(78,998,049)
Total property, plant and equipment, net	464,998,932	472,319,683
OTHER ASSETS:		
Cash and other assets held by affiliates	45,369	39,731
Other	121,527	32,944
Total other assets	166,896	72,675
TOTAL ASSETS	$ 597,293,530	$ 592,265,747

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

Table of Contents

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited)

LIABILITIES AND SHAREHOLDERS EQUITY

	September 30, 2010	June 30, 2010
CURRENT LIABILITIES:		
Accounts payable	$ 12,523,124	$ 34,219,769
Royalties and working interests payable	34,986,037	30,774,444
Accrued liabilities	4,652,850	2,647,435
Joint interest advances	1,333,980	739,464
Accrued exploration and development	5,020,513	9,263,438
Income tax payable	6,402,332	843,755
Total current liabilities	64,918,836	78,488,305
DEFERRED TAX LIABILITY	131,361,058	131,290,992
ASSET RETIREMENT OBLIGATION	5,387,421	5,156,642
SHAREHOLDERS EQUITY:		
Common stock, $0.04 par value, 50,000,000 shares authorized, 19,982,563 shares issued and 15,664,666 outstanding at September 30, 2010, 19,982,563 shares issued and 15,684,666 outstanding at June 30, 2010	799,300	799,300
Additional paid-in capital	78,188,905	77,967,702
Treasury stock at cost (4,317,897 and 4,297,897 shares at September 30, 2010 and June 30, 2010, respectively)	(82,885,245)	(82,019,429)
Retained earnings	399,523,255	380,582,235
Total shareholders equity	395,626,215	377,329,808
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 597,293,530	$ 592,265,747

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 September 30, 2010	Three Months Ended September 30, 2009
REVENUES:		
Natural gas, oil and liquids sales	$ 55,084,215	$ 35,602,471
Total revenues	55,084,215	35,602,471
EXPENSES:		
Operating expenses	4,940,795	3,456,353
Exploration expenses	1,377,939	373,933
Depreciation, depletion and amortization	15,226,744	8,956,941
General and administrative expenses	3,083,553	1,438,541
Total expenses	24,629,031	14,225,768
NET INCOME FROM CONTINUING OPERATIONS BEFORE OTHER INCOME AND INCOME TAXES	30,455,184	21,376,703
OTHER INCOME (EXPENSE):		
Interest expense	(63,014)	(156,133)
Interest income	350	147,230
NET INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	30,392,520	21,367,800
Provision for income taxes	(11,451,500)	(7,901,939)
NET INCOME FROM CONTINUING OPERATIONS	18,941,020	13,465,861
NET INCOME ATTRIBUTABLE TO COMMON STOCK	$ 18,941,020	$ 13,465,861
NET INCOME PER SHARE:		
Basic	$ 1.21	$ 0.85
Diluted	$ 1.20	$ 0.83
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:		
Basic	15,666,079	15,827,436
Diluted	15,780,318	16,144,643

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

Table of Contents

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Three Months Ended September 30, 2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 18,941,020	$ 13,465,861
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion and amortization	15,226,744	8,956,941
Exploration expenditures	622,856	543,168
Deferred income taxes	70,066	(1,838,232)
Stock-based compensation	221,203	126,333
Changes in operating assets and liabilities:		
Decrease (increase) in accounts receivable and other	(1,383,172)	8,239,244
Decrease in accounts payable and advances from joint owners	(18,176,388)	(9,398,960)
Increase (decrease) in other accrued liabilities	2,005,415	(7,672,176)
Increase in income taxes payable	6,702,537	9,740,171
Other	533,190	(361,033)
Net cash provided by operating activities	24,763,471	21,801,317
CASH FLOWS FROM INVESTING ACTIVITIES:		
Natural gas and oil exploration and development expenditures	(12,502,350)	(1,718,299)
Additions to furniture and equipment	(11,520)	
Investment in affiliates	(99,996)	325,181
Net cash used in investing activities	(12,613,866)	(1,393,118)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Purchase of common stock	(865,816)	
Debt issuance costs	(15,712)	
Net cash used in financing activities	(881,528)	
NET INCREASE IN CASH AND CASH EQUIVALENTS	11,268,077	20,408,199
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	52,469,144	44,371,324
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 63,737,221	$ 64,779,523
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for taxes, net	$ 4,678,897	$
Cash paid for interest	$ 63,014	$ 63,014

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

Table of Contents

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

(Unaudited)

	Common Stock					Total
	Shares	Amount	Paid-in Capital	Treasury Stock	Retained Earnings	Shareholders Equity
Balance at June 30, 2010	15,684,666	$ 799,300	$ 77,967,702	$ (82,019,429)	$ 380,582,235	$ 377,329,808
Exercise of stock options						$
Tax benefit of exercising stock options						$
Issuance of restricted common stock						$
Treasury shares at cost	(20,000)			(865,816)		$ (865,816)
Expense of stock options			221,203			$ 221,203
Net income					18,941,020	$ 18,941,020
Balance at September 30, 2010	15,664,666	$ 799,300	$ 78,188,905	$ (82,885,245)	$ 399,523,255	$ 395,626,215

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

7

Table of Contents

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

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

2. Summary of Significant Accounting Policies

The application of GAAP involves certain assumptions, judgments, choices and estimates that affect reported amounts of assets, liabilities, revenues and expenses. Actual results could differ from these estimates. Contango s significant accounting policies are described below.

Successful Efforts Method of Accounting. The Company follows the successful efforts method of accounting for its natural gas and oil activities. Under the successful efforts method, lease acquisition costs and all development costs are capitalized. Unproved properties are reviewed quarterly to determine if there has been impairment of the carrying value, and any such impairment is charged to expense in the period. Exploratory drilling costs are capitalized until the results are determined. If proved reserves are not discovered, the exploratory drilling costs are expensed. Other exploratory costs, such as seismic costs and other geological and geophysical expenses, are expensed as incurred. The provision for depreciation, depletion and amortization is based on the capitalized costs as determined above. Depreciation, depletion and amortization is on a field by field basis using the unit of production method, with lease acquisition costs amortized over total proved reserves and other costs amortized over proved developed reserves.

When circumstances indicate that proved properties may be impaired, the Company compares expected undiscounted future net cash flows on a field by field basis to the unamortized capitalized cost of the asset. If the future undiscounted net cash flows, based on the Company s estimate of future natural gas and oil prices and operating costs and anticipated production from proved reserves, are lower than the unamortized capitalized cost, then the capitalized cost is reduced to fair market value. No impairment charges were incurred for the three months ended September 30, 2010 or 2009.

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 offshore exploration programs. The Company classifies such property sales as discontinued operations.

Cash Equivalents. Cash equivalents are considered to be highly liquid investment grade investments having an original maturity of 90 days or less. As of September 30, 2010, the Company had approximately $63.7 million in cash and cash equivalents. Of this amount, approximately $26.7 million was invested in U.S. Treasury money market funds and the remaining $37.0 million was invested in overnight U.S. Treasury funds.

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

Table of Contents

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Stock-Based Compensation. The Company applies the fair value based method to account for stock-based compensation. Under this method, compensation cost is measured at the grant date based on the fair value of the award and is recognized over the award vesting period. The fair value of each award is estimated as of the date of grant using the Black-Scholes option-pricing model. The Company also classifies the benefits of tax deductions in excess of the compensation cost recognized for the options (excess tax benefit) as financing cash flows. No options were granted for the three months ended September 30, 2010 or 2009.

The Company s 1999 Stock Incentive Plan expired in August 2009. Any outstanding options issued under the plan will be converted into securities if exercised prior to their expiration date, which expiration dates range from December 2010 to September 2013. On September 15, 2009, the Company s Board of Directors adopted the Contango Oil & Gas Company Annual Incentive Plan (the 2009 Plan), which was approved by shareholders on November 19, 2009. Under the 2009 Plan, the Company s Board of Directors may grant stock options, restricted stock awards and other stock-based awards to officers or other employees of the Company. Awards made under the 2009 Plan are subject to such restrictions, terms and conditions, including forfeitures, if any, as may be determined by the Board. Grants of service-based awards are valued at our common stock price at the date of grant. The Company did not grant stock-based awards to any officer or director during the three months ended September 30, 2010 or 2009.

During the three months ended September 30, 2010 and 2009, the Company recorded stock-based compensation charges of $221,203 and $126,333, respectively, to general and administrative expense for restricted stock and option awards. These amounts do not reflect compensation actually received by the individuals, but rather represent expense recognized in the Company s consolidated financial statements that relate to restricted stock and option awards granted in previous fiscal years.

3. Natural Gas and Oil Exploration and Production Risk

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

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

Table of Contents

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

4. Customer Concentration Credit Risk

The customer base for the Company is concentrated in the natural gas and oil industry. Major purchasers of our natural gas and oil for the three months ended September 30, 2010 were ConocoPhillips Company, Shell Trading US Company, Trans Louisiana Gas Pipeline, Inc., NJR Energy Services and Enterprise Products Operating LLC. Our sales to these companies are not secured with letters of credit and in the event of non-payment, we could lose up to two months of revenues. The loss of two months of revenues would have a material adverse effect on our financial position, but there are numerous other potential purchasers of our production.

5. Other Receivable

On February 24, 2010, a dredge contracted by the Army Corps of Engineers to dredge the Atchafalaya River Channel ruptured the Company s 20 pipeline that runs from our Eugene Island 11 gathering platform to the Eugene Island 63 platform where our pipeline joins a third-party pipeline that transports our production to shore. The pipeline was repaired and production resumed on March 31, 2010. We believe the repairs will be covered by our insurance policy, subject to a deductible. We have recorded a receivable of approximately $3.2 million related to this incident in the Consolidated Balance Sheet as of September 30, 2010 and June 30, 2010.

6. Net Income per Common Share

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

	Three Months Ended September 30, 2010		
	Income	**Weighted Average Shares**	**Per Share**
Income from continuing operations	$ 18,941,020	15,666,079	$ 1.21
Basic Earnings per Share:			
Net income attributable to common stock	$ 18,941,020	15,666,079	$ 1.21
Effect of Potential Dilutive Securities:			
Stock options		114,239	
Income from continuing operations	$ 18,941,020	15,780,318	$ 1.20
Diluted Earnings per Share:			
Net income attributable to common stock	$ 18,941,020	15,780,318	$ 1.20

Table of Contents

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

6. Net Income per Common Share (continued)

	Three Months Ended September 30, 2009		
	Income	**Weighted Average Shares**	**Per Share**
Income from continuing operations	$ 13,465,861	15,827,436	$ 0.85
Basic Earnings per Share:			
Net income attributable to common stock	$ 13,465,861	15,827,436	$ 0.85
Effect of Potential Dilutive Securities:			
Stock options		315,663	
Restricted shares		1,544	
Income from continuing operations	$ 13,465,861	16,144,643	$ 0.83
Diluted Earnings per Share:			
Net income attributable to common stock	$ 13,465,861	16,144,643	$ 0.83

Options to purchase 85,000 and 45,000 shares of common stock were outstanding as of September 30, 2010 and 2009, respectively, but were not included in the computation of diluted earnings per share for the three months ended September 30, 2010 or 2009. These options were excluded because either (i) the options exercise price was greater than the average market price of the common shares, or (ii) application of the treasury method to in-the-money options made some of the options anti-dilutive.

7. Related Party Transactions

The Company s wholly-owned subsidiary, Conterra Company (Conterra), has entered into a joint venture with Patara Oil & Gas LLC (Patara), a privately held oil and gas company, to develop proved undeveloped Cotton Valley gas reserves in Panola County, Texas. B.A. Berilgen, a member of the Company s board of directors, is the Chief Executive Officer of Patara.

In March 2006, Contango Offshore Exploration LLC (COE) executed a Promissory Note (the COE Note) to the Company to finance its share of development costs in Grand Isle 72. The COE Note was payable upon demand and carried an annual interest rate of 10%. As of May 31, 2010, COE owed the Company $4.3 million under the COE Note, and owed an additional $1.6 million in accrued and unpaid interest. Effective June 1, 2010, COE was dissolved and the Company assumed its 65.6% of the obligation of COE, while the other member of COE assumed the remaining 34.4%, or approximately $2.0 million. This $2.0 million is reflected as a note receivable in the Consolidated Balance Sheet of the Company as of September 30, 2010 and June 30, 2010. The new note receivable was payable on demand and carried no interest rate. On October 27, 2010 this new note was paid in full.

11

CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

8. Subsequent Events

On October 22, 2010, the Company completed the arrangement of a secured revolving credit agreement with Amegy Bank (the Credit Agreement) to replace the expiring credit agreement with BBVA Compass Bank. The Credit Agreement currently has a $40 million hydrocarbon borrowing base and will be available to fund the Company s offshore Gulf of Mexico exploration and development activities, as well as repurchase shares of common stock, pay dividends, and to fund working capital as needed. The Credit Agreement is secured by substantially all of the assets of the Company. Borrowings under the Credit Agreement bear interest at LIBOR plus 2.5%, subject to a LIBOR floor of 0.75%. The principal is due October 1, 2014, and may be prepaid at any time with no prepayment penalty. An arrangement fee of $300,000 was paid on October 1, 2010 in connection with the facility and a commitment fee of 0.375% will be paid on unused borrowing capacity. The Credit Agreement contains customary covenants including limitations on additional indebtedness.

Effective October 1, 2010, the Company purchased an additional 7.5% working interest and 6.0% net revenue interest in Ship Shoal 263 for approximately $7.5 million from Juneau Exploration, L.P. (JEX). The Company now owns a 100% working interest and 80% net revenue interest in this well.

On October 27, 2010, the Company received approximately $2.0 million from JEX, the other member of COE, which paid off the COE Note in full.

On September 29, 2010, Contango ORE, Inc. (CORE), a wholly-owned subsidiary of the Company, filed a Form 10 with the SEC. Once the Form 10 is declared effective, we anticipate that CORE will acquire all the assets and obligations of Contango Mining Company, another wholly-owned subsidiary of the Company and that we will distribute the common stock of CORE to Contango s stockholders of record as of October 15, 2010 on the basis of one share of common stock of CORE for each ten shares of Contango s common stock then outstanding. CORE was formed to explore for (i) gold and associated minerals and (ii) rare earth elements, in the State of Alaska.

Table of Contents

Available Information

General information about us can be found on our Website at www.contango.com. Our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, as well as any amendments and exhibits to those reports, are available free of charge through our Website as soon as reasonably practicable after we file or furnish them to the Securities and Exchange Commission (SEC).

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the consolidated financial statements and the accompanying notes and other information included elsewhere in this Form 10-Q and in our Form 10-K for the fiscal year ended June 30, 2010, previously filed with the SEC.

Cautionary Statement about Forward-Looking Statements

Some of the statements made in this report may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934, as amended. The words and phrases should be , will be , believe , expect , anticipate , estimate , forecast , goal and similar expressions identify forward-looking statements and express our expectations about future events. These include such matters as:

Our financial position

Business strategy, including outsourcing

Meeting our forecasts and budgets

Anticipated capital expenditures

Drilling of wells

Natural gas and oil production and reserves

Timing and amount of future discoveries (if any) and production of natural gas and oil

Operating costs and other expenses

Cash flow and anticipated liquidity

Prospect development

Property acquisitions and sales

New governmental laws and regulations

Although we believe the expectations reflected in such forward-looking statements are reasonable, such expectations may not occur. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from future results expressed or implied by the forward-looking statements. These factors include, among others:

Low and/or declining prices for natural gas and oil

Natural gas and oil price volatility

Operational constraints, start-up delays and production shut-ins at both operated and non-operated production platforms, pipelines and gas processing facilities

The risks associated with acting as the operator in drilling deep high pressure and temperature wells in the Gulf of Mexico, including well blowouts and explosions

The risks associated with exploration, including cost overruns and the drilling of non-economic wells or dry holes, especially in prospects in which the Company has made a large capital commitment relative to the size of the Company s capitalization structure

The timing and successful drilling and completion of natural gas and oil wells

Availability of capital and the ability to repay indebtedness when due

Availability of rigs and other operating equipment

Ability to raise capital to fund capital expenditures

Timely and full receipt of sale proceeds from the sale of our production

The ability to find, acquire, market, develop and produce new natural gas and oil properties

Interest rate volatility

Uncertainties in the estimation of proved reserves and in the projection of future rates of production and timing of development expenditures

Operating hazards attendant to the natural gas and oil business

Downhole drilling and completion risks that are generally not recoverable from third parties or insurance

Potential mechanical failure or under-performance of significant wells, production facilities, processing plants or pipeline mishaps

Weather

Availability and cost of material and equipment

Delays in anticipated start-up dates

Actions or inactions of third-party operators of our properties

Actions or inactions of third-party operators of pipelines or processing facilities

The ability to find and retain skilled personnel

Strength and financial resources of competitors

Federal and state regulatory developments and approvals

Environmental risks

Worldwide economic conditions

The ability to construct and operate offshore infrastructure, including pipeline and production facilities

The continued compliance by the Company with various pipeline and gas processing plant specifications for the gas and condensate produced by the Company

Drilling and operating costs, production rates and ultimate reserve recoveries in our Eugene Island 10 (Dutch) and State of Louisiana (Mary Rose) acreage

Restrictions on permitting activities

Expanded rigorous monitoring and testing requirements

Legislation that may regulate drilling activities and increase or remove liability caps for claims of damages from oil spills

Ability to obtain insurance coverage on commercially reasonable terms

Accidental spills, blowouts and pipeline ruptures

Impact of new and potential legislative and regulatory changes on Gulf of Mexico operating and safety standards

You should not unduly rely on these forward-looking statements in this report, as they speak only as of the date of this report. Except as required by law, we undertake no obligation to publicly release any revisions to these forward-looking statements to reflect events or circumstances occurring after the date of this report or to reflect the occurrence of unanticipated events. See the information under the heading Risk Factors in this Form 10-Q for some of the important factors that could affect our financial performance or could cause actual results to differ materially from estimates contained in forward-looking statements.

Overview

Contango is a Houston-based, independent natural gas and oil company. The Company s core business is to explore, develop, produce and acquire natural gas and oil properties primarily offshore in the Gulf of Mexico. Contango Operators, Inc. (COI), our wholly-owned subsidiary, acts as operator on certain offshore prospects.

Our Strategy

Our exploration strategy is predicated upon two core beliefs: (1) that the only competitive advantage in the commodity-based natural gas and oil business is to be among the lowest cost producers and (2) that virtually all the exploration and production industry s value creation occurs through the drilling of successful exploratory wells. As a result, our business strategy includes the following elements:

Funding exploration prospects generated by Juneau Exploration, L.P., our alliance partner. We depend primarily upon our alliance partner, Juneau Exploration, L.P. (JEX), for prospect generation expertise. JEX is experienced and has a successful track record in exploration.

Using our limited capital availability to increase our reward/risk potential on selective prospects. We have concentrated our risk investment capital in our offshore Gulf of Mexico prospects. Exploration prospects are inherently risky as they require large amounts of capital with no guarantee of success. COI drills and operates our offshore prospects. Should we be successful in any of our offshore prospects, we will have the opportunity to spend significantly more capital to complete development and bring the discovery to producing status.

Sale of proved properties. From time-to-time as part of our business strategy, we have sold and in the future expect to continue to sell some or a substantial portion of our proved reserves and assets to capture current value, using the sales proceeds to further our offshore exploration activities. Since its inception, the Company has sold approximately $484 million worth of natural gas and oil properties, and views periodic reserve sales as an opportunity to capture value, reduce reserve and price risk, and as a source of funds for potentially higher rate of return natural gas and oil exploration opportunities.

Controlling general and administrative and geological and geophysical costs. Our goal is to be among the most efficient in the industry in revenue and profit per employee and among the lowest in general and administrative costs. We plan to continue outsourcing our geological, geophysical, and reservoir engineering and land functions, and partnering with cost efficient operators. We have eight employees.

Structuring incentives to drive behavior. We believe that equity ownership aligns the interests of our employees and stockholders. Our directors and executive officers beneficially own or have voting control over approximately 22% of our common stock.

Impact of Deepwater Horizon Incident and Federal Deepwater Moratorium

In April 2010, the deepwater Gulf of Mexico drilling rig Deepwater Horizon, engaged in drilling operations for another operator, sank after an apparent blowout and fire. The resulting leak caused a significant oil spill. In May 2010, in response to the incident, the President of the United States announced a six-month moratorium on drilling in the deepwater Gulf of Mexico (Federal Deepwater Moratorium or the Moratorium). Under the Federal Deepwater Moratorium, no new drilling, including sidetracks and bypasses of wells, was allowed in water depths greater than 500 feet. For operators such as Contango that operate in less than 500 feet of water, there are new, more restrictive requirements on permitting activities on the Outer Continental Shelf.

During the quarter ended September 30, 2010, the Outer Continental Shelf Safety Oversight Board, established by the Secretary of the Interior, issued its recommendations for the strengthening of permitting, inspections, enforcement and environmental stewardship. In addition, the Bureau of Ocean Energy Management, Regulation and Enforcement (BOEMRE) developed an implementation plan for the recommendations, many of which are already underway or planned.

On September 30, 2010, the Department of the Interior announced two new rules (The Drilling Safety Rule and the Workplace Safety Rule) that are intended to improve drilling safety by strengthening requirements for safety equipment, well control systems, and blowout prevention practices on offshore oil and gas operations, and improve workplace safety. The Secretary of the Interior lifted the Moratorium on October 12, 2010.

The Deepwater Horizon incident is likely to have a significant and lasting effect on the US offshore energy industry, and will likely result in a number of fundamental changes, including heightened regulatory scrutiny, more stringent operating and safety standards, changes in equipment requirements and the availability and cost of insurance, as well as increased politicization of the industry. These changes may result in increases in our operating and development costs and extend project development timelines because of new regulatory requirements. There may be other impacts of which we are not aware at this time.

Table of Contents

Finally, we expect the future availability and cost of insurance to be impacted by the recent Deepwater Horizon incident. Impacts could include: tighter underwriting standards, limitations on scope and amount of coverage, and higher premiums, and will depend, in part, on future changes in laws and regulations regarding exploration and production activities in the Gulf of Mexico, including possible increases in liability caps for claims of damages from oil spills. We will continue to monitor the expected regulatory and legislative response and its impact on the insurance market and our overall risk profile, and adjust our risk and insurance program to provide protection, at a level that we can afford considering the cost of insurance and our desired rates of return, against disruption to our operations and cash flows.

Exploration Alliance with JEX

JEX is a private company formed for the purpose of assembling domestic natural gas and oil prospects. Under our agreement with JEX, JEX generates natural gas and oil prospects and evaluates exploration prospects generated by others. JEX focuses on the Gulf of Mexico, and generates offshore exploration prospects either individually, or via our 32.3% owned affiliated company, Republic Exploration LLC (REX) (see Offshore Gulf of Mexico Exploration Joint Ventures below). We do not have a written agreement with JEX which contractually obligates them to provide us with their services.

Offshore Gulf of Mexico Exploration Joint Ventures

Contango, through its wholly-owned subsidiary COI, and its partially-owned subsidiary REX, conducts exploration activities in the Gulf of Mexico. As of October 31, 2010, Contango, through COI and REX, had an interest in 28 offshore leases. See Offshore Properties for additional information on our offshore properties.

Contango Operators, Inc

COI, a wholly-owned subsidiary of the Company, was formed for the purpose of drilling and operating wells in the Gulf of Mexico. Additionally, COI expects to acquire significant working interests in offshore exploration and development opportunities in the Gulf of Mexico, usually under a farm-out agreement, or similar agreement, with REX. COI may also acquire and operate significant working interests in offshore exploration and development opportunities under farm-in agreements with third parties.

The Company s offshore operated production consists of 11 wells located on federal and State of Louisiana leases in the shallow waters of the Gulf of Mexico. These 11 wells produce via the following three platforms:

Eugene Island 11 Platform

As of October 31, 2010, the Company-owned and operated platform at Eugene Island 11 was processing approximately 51.1 Mmcfed, net to Contango. This platform was designed with a capacity of 500 million cubic feet per day (Mmcfd) and 6,000 barrels of oil per day (bopd). This platform services production from the Company s four Mary Rose wells and its Eloise North well, which are all located in State of Louisiana waters, as well as our Dutch #4 well and Eloise South well, which are both located in federal waters. From the Eugene Island 11 platform, the gas and condensate flow to our Eugene Island 63 auxiliary platform via our 20 pipeline, which has been designed with a capacity of 330 Mmcfd and 6,000 bopd, and then from the Eugene Island 63 auxiliary platform to third-party owned and operated on-shore processing facilities near Patterson, Louisiana.

In September 2010 the Company completed installing a companion platform adjacent to the Eugene Island 11 Platform (the H-CMP Platform). The H-CMP Platform, together with two newly laid pipelines, enables us to redirect up to five of the seven wells that produce to the Eugene Island 11 platform and send that natural gas and oil production to alternate markets. As of September 30, 2010, the Company had invested approximately $3.8 million to build and install the H-CMP Platform and pipelines.

Table of Contents

On February 24, 2010, a dredge contracted by the Army Corps of Engineers to dredge the Atchafalaya River Channel ruptured the Company s 20 pipeline that runs from our Eugene Island 11 gathering platform to our Eugene Island 63 auxiliary platform. All wells serviced by the platform were immediately shut-in upon pipeline rupture, and we immediately implemented our spill response plan. The Company estimates that a minimal and immaterial quantity of production was lost. The pipeline was repaired and production resumed on March 31, 2010. We believe the repairs will be covered by our insurance policy, subject to a deductible. We have an approximate 53% ownership interest in the pipeline.

Eugene Island 24 Platform

As of October 31, 2010 this third-party owned and operated production platform at Eugene Island 24 was processing approximately 32.5 Mmcfed, net to Contango. This platform was designed with a capacity of 100 Mmcfd and 3,000 bopd. This platform services production from the Company s Dutch #1, #2 and #3 federal wells.

Ship Shoal 263 Platform

As of October 31, 2010, the Company-owned and operated Ship Shoal 263 platform was processing approximately 17.8 Mmcfed, net to Contango. This platform was designed with a capacity of 40 Mmcfd and 5,000 bopd. This platform services production from our Nautilus well which began producing in June 2010.

Other Activities

In September 2010, we spud our Galveston Area 277L prospect (His Dudeness), a wildcat exploration well in the Gulf of Mexico. The Company will pay 100% of drilling costs, estimated to be approximately $10.0 million. Additionally, we have submitted an exploration permit with the BOEMRE to drill our next wildcat exploration well, Vermillion Island 170 (Swimmy), in the Gulf of Mexico. We hope to be approved to drill this well prior to December 31, 2010.

Our Eloise South prospect was spud on block Eugene Island 10 in March 2010 and began producing in July 2010. The well is currently shut-in while undergoing diagnostic testing to determine the cause for underperforming flow rates. Upon depletion of our Eloise South well, our well bore may be completed up-hole and produce in the Cib-op sand as our Dutch #5 well. The Company has a 26.9% working interest (21.5% net revenue interest) in Eloise South, inclusive of our ownership interest in REX, and will have a 47.05% working interest (38.1% net revenue interest) in Dutch #5.

Republic Exploration LLC

West Delta 36, a REX prospect, is operated by a third party. The Company depends on a third-party operator for the operation and maintenance of this production platform. As of October 31, 2010 the well was producing at an 8/8ths rate of approximately 2.9 Mmcfed. REX has a 25.0% working interest (WI), and a 20.0% net revenue interest (NRI), in this well.

Table of Contents

Offshore Properties

Producing Properties. The following table sets forth the interests owned by Contango through its related entities in the Gulf of Mexico which were capable of producing natural gas or oil as of October 31, 2010:

Area/Block	WI	NRI	Status
Eugene Island 10 #D-1 (Dutch #1)	47.05%	38.1%	Producing
Eugene Island 10 #E-1 (Dutch #2)	47.05%	38.1%	Producing
Eugene Island 10 #F-1 (Dutch #3)	47.05%	38.1%	Producing
Eugene Island 10 #G-1 (Dutch #4)	47.05%	38.1%	Producing
Eugene Island 10 #I-1 (Eloise South)	23.76%	19.0%	Shut-in
S-L 18640 #1 (Mary Rose #1)	53.21%	40.5%	Producing
S-L 19266 #1 (Mary Rose #2)	53.21%	38.7%	Producing
S-L 19266 #2 (Mary Rose #3)	53.21%	38.7%	Producing
S-L 18860 #1 (Mary Rose #4)	34.58%	25.5%	Producing
S-L 19266 #3 (Eloise North)	36.90%	26.9%	Producing