

CREDO PETROLEUM CORP
Form 10-Q
September 15, 2008
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended July 31, 2008

**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: 0-8877

CREDO PETROLEUM CORPORATION

(Exact name of registrant as specified in its charter)

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Colorado
(State or other jurisdiction of incorporation or organization)

84-0772991
(IRS Employer Identification No.)

1801 Broadway, Suite 900, Denver, Colorado
(Address of principal executive offices)

80202
(Zip Code)

303-297-2200

(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, a non-accelerated filer, or a smaller reporting company. See 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 Non-accelerated filer Smaller reporting company
(Do not check if a 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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, net of treasury stock, as of the latest practicable date.

Date	Class	Outstanding
Sept. 15, 2008	Common stock, \$.10 par value	10,507,000

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EXPLANATORY NOTE

On September 2, 2008, in connection with preparing its quarterly report for third quarter 2008, management of CREDO Petroleum Corporation (the company) and the Audit Committee of its Board of Directors determined that the contemporaneous formal documentation it had historically prepared to support its initial hedge designations in connection with the company's natural gas hedging program does not meet the technical requirements to qualify for cash flow hedge accounting treatment in accordance with SFAS 133. The primary reason for this determination was that the formal hedge documentation lacks specificity of the hedged items and therefore, the cash flow designations failed to meet hedge documentation requirements for cash flow hedge accounting treatment. Consequently, the unrealized gain or loss should have been recorded in the consolidated statements of operations as a component of income before income taxes. Under the cash flow accounting treatment used by the company, the fair values of the hedge contracts was recognized in the consolidated balance sheets with the resulting unrealized gain or loss, net of income taxes, recorded initially in accumulated other comprehensive income and later reclassified through earnings when the hedged production affected earnings.

The company will restate its consolidated financial statements for fiscal years ended October 31, 2005, 2006, 2007 and the first and second quarters of fiscal year ending October 31, 2008. There is no effect in any period on overall cash flows, EBITDA, total assets, total liabilities or total stockholders' equity. The restatement did not have any impact on any of the Company's financial covenants under its line of credit. Details of the effect of the restatement are indicated in Note 1 to the Consolidated Financial Statements.

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CREDO PETROLEUM CORPORATION AND SUBSIDIARIES

Quarterly Report on Form 10-Q For the Period Ended July 31, 2008

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The terms CREDO , Company , we , our , and us refer to CREDO Petroleum Corporation and its subsidiaries unless the context suggests otherwise.

Table of Contents**PART I - FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****CREDO PETROLEUM CORPORATION AND SUBSIDIARIES****Consolidated Balance Sheets**

	July 31, 2008 (Unaudited)	October 31, 2007 (Restated)
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 23,795,000	\$ 7,285,000
Short-term investments	3,595,000	6,383,000
Receivables:		
Accrued oil and gas sales	3,423,000	1,647,000
Trade	580,000	602,000
Derivative Assets		443,000
Other current assets	63,000	55,000
Total current assets	31,456,000	16,415,000
Long-term assets:		
Oil and gas properties, at cost, using full cost method:		
Unevaluated oil and gas properties	11,427,000	7,791,000
Evaluated oil and gas properties	55,258,000	51,691,000
Less: accumulated depreciation, depletion and amortization of oil and gas properties	(24,616,000)	(22,108,000)
Net oil and gas properties, at cost, using full cost method	42,069,000	37,374,000
Exclusive license agreement, net of amortization of \$553,000 in 2008 and \$501,000 in 2007	146,000	198,000
Compressor and tubular inventory to be used in development	2,478,000	1,090,000
Other, net	344,000	272,000
Total assets	\$ 76,493,000	\$ 55,349,000
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	\$ 882,000	\$ 1,639,000
Revenue distribution payable	1,493,000	979,000
Derivative liabilities	673,000	
Other accrued liabilities	506,000	852,000
Income taxes payable	472,000	434,000
Total current liabilities	4,026,000	3,904,000
Long Term Liabilities:		
Deferred income taxes, net	10,374,000	9,204,000
Derivative liabilities due in more than one year	193,000	
Exclusive license obligation, less current obligations of \$77,000 in 2008 and 2007	85,000	85,000

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Asset retirement obligation	1,118,000	1,016,000
Total liabilities	15,796,000	14,209,000
Stockholders' Equity:		
Preferred stock, no par value, 5,000,000 shares authorized, none issued		
Common stock, \$.10 par value, 20,000,000 shares authorized, 10,660,000 shares issued in 2008 and 9,510,000 in 2007	1,066,000	951,000
Capital in excess of par value	31,174,000	15,913,000
Treasury stock at cost, 153,000 shares in 2008 and 215,000 in 2007	(361,000)	(506,000)
Retained earnings	28,818,000	24,782,000
Total stockholders' equity	60,697,000	41,140,000
Total liabilities and stockholders' equity	\$ 76,493,000	\$ 55,349,000

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

Table of Contents**CREDO PETROLEUM CORPORATION AND SUBSIDIARIES****Consolidated Statements of Operations****(Unaudited)**

	Nine Months Ended July 31,		Three Months Ended July 31,	
	2008	2007 (Restated)	2008	2007 (Restated)
REVENUES:				
Oil and gas sales	\$ 14,321,000	\$ 11,121,000	\$ 5,646,000	\$ 3,613,000
Investment income and other	125,000	685,000	49,000	233,000
	14,446,000	11,806,000	5,695,000	3,846,000
COSTS AND EXPENSES:				
Oil and gas production	2,883,000	2,546,000	1,045,000	837,000
Depreciation, depletion and amortization	2,594,000	2,782,000	843,000	883,000
General and administrative	1,034,000	1,020,000	337,000	376,000
Interest	7,000	20,000	2,000	6,000
	6,518,000	6,368,000	2,227,000	2,102,000
INCOME FROM OPERATIONS	7,928,000	5,438,000	3,468,000	1,744,000
GAIN (LOSS) ON DERIVATIVE CONTRACTS				
Realized gains (losses) from derivative contracts	(1,024,000)	1,187,000	(1,876,000)	201,000
Unrealized gains (losses) from derivative contracts	(1,309,000)	423,000	3,015,000	1,466,000
	(2,333,000)	1,610,000	1,139,000	1,667,000
INCOME BEFORE INCOME TAXES	5,595,000	7,048,000	4,607,000	3,411,000
INCOME TAXES	(1,559,000)	(2,010,000)	(1,264,000)	(964,000)
NET INCOME	\$ 4,036,000	\$ 5,038,000	\$ 3,343,000	\$ 2,447,000
EARNINGS PER SHARE OF COMMON STOCK				
BASIC	\$.43	\$.54	\$.35	\$.26
EARNINGS PER SHARE OF COMMON STOCK				
DILUTED	\$.42	\$.54	\$.34	\$.26
Weighted average number of shares of Common Stock and dilutive securities:				
Basic	9,430,000	9,268,000	9,690,000	9,282,000
Diluted	9,509,000	9,402,000	9,772,000	9,406,000

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

Table of Contents**CREDO PETROLEUM CORPORATION AND SUBSIDIARIES****Statement of Stockholders' Equity and Comprehensive Income****(Unaudited)**

For the Nine Months Ended July 31, 2008

	Common Stock		Capital In	Treasury	Retained	Total
	Shares	Amount	Excess Of	Stock	Earnings	Stockholders
			Par Value			Equity
Balance, October 31, 2007						
Restated	9,510,000	\$ 951,000	\$ 15,913,000	\$ (506,000)	\$ 24,782,000	\$ 41,140,000
Comprehensive income:						
Net income					4,036,000	4,036,000
Sale of Common Stock	1,150,000	115,000	14,996,000			15,111,000
Exercise of common stock options			221,000	145,000		366,000
Compensation expense associated with unvested portion of previously granted stock options			44,000			44,000
Balance, July 31, 2008	10,660,000	\$ 1,066,000	\$ 31,174,000	\$ (361,000)	\$ 28,818,000	\$ 60,697,000

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

Table of Contents**CREDO PETROLEUM CORPORATION AND SUBSIDIARIES****Consolidated Statements of Cash Flows****(Unaudited)**

	Nine Months Ended July 31,	
	2008	2007 (Restated)
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 4,036,000	\$ 5,038,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion and amortization	2,594,000	2,782,000
Unrealized (gains) loss on derivative contracts	1,309,000	(423,000)
Deferred income taxes	1,170,000	1,566,000
Compensation expense related to stock options granted	44,000	138,000
Other	38,000	62,000
Changes in operating assets and liabilities:		
(Gain) loss on short term investments	67,000	
Proceeds from short-term investments	2,721,000	1,492,000
Purchase of short-term investments		(2,169,000)
Accrued oil and gas sales	(1,776,000)	180,000
Trade receivables	22,000	371,000
Other current assets	(8,000)	(158,000)
Accounts payable and accrued liabilities	(589,000)	(831,000)
Income taxes payable	38,000	226,000
NET CASH PROVIDED BY OPERATING ACTIVITIES	9,666,000	8,274,000
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to oil and gas properties	(8,414,000)	(6,794,000)
Proceeds from sale of oil and gas properties	1,275,000	171,000
Changes in other long-term assets	(1,494,000)	202,000
NET CASH USED IN INVESTING ACTIVITIES	(8,633,000)	(6,421,000)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Sale of common stock	15,111,000	
Proceeds from exercise of stock options (62,000 options in 2008 and 67,000 options in 2007)	366,000	272,000
NET CASH PROVIDED BY FINANCING ACTIVITIES	15,477,000	272,000
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	16,510,000	2,125,000
CASH AND CASH EQUIVALENTS:		
Beginning of period	7,285,000	4,577,000
End of period	\$ 23,795,000	\$ 6,702,000
Supplemental cash flow information:		
Cash paid during the period for income taxes	\$ 352,000	\$ 207,000
Additions to oil & gas properties in current liabilities	\$ 383,000	

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

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CREDO PETROLEUM CORPORATION AND SUBSIDIARIES

Notes To Consolidated Financial Statements (Unaudited)

July 31, 2008

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with U. S. generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U. S. generally accepted accounting principles for complete financial statements. In the opinion of management, the consolidated financial statements contain all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the company's results for the periods presented. These consolidated financial statements should be read in conjunction with the company's Annual Report on Form 10-K/A for the fiscal year ended October 31, 2007.

On September 2, 2008, in connection with preparing its quarterly report for third quarter 2008, management of CREDO Petroleum Corporation (the company) and the Audit Committee of its Board of Directors determined that the contemporaneous formal documentation it had historically prepared to support its initial hedge designations in connection with the company's natural gas hedging program does not meet the technical requirements to qualify for cash flow hedge accounting treatment in accordance with SFAS 133. The primary reason for this determination was that the formal hedge documentation lacks specificity of the hedged items and therefore, the cash flow designations failed to meet hedge documentation requirements for cash flow hedge accounting treatment. Consequently, the unrealized gain or loss should have been recorded in the consolidated statements of operations as a component of income before income taxes. Under the cash flow accounting treatment used by the company, the fair values of the hedge contracts was recognized in the consolidated balance sheets with the resulting unrealized gain or loss, net of income taxes, recorded initially in accumulated other comprehensive income and later reclassified through earnings when the hedged production affected earnings.

The company will restate its consolidated financial statements for fiscal years ended October 31, 2005, 2006, 2007 and the first and second quarters of fiscal year ending October 31, 2008. There is no effect in any period on overall cash flows, EBITDA, total assets, total liabilities or total stockholders' equity. The cumulative effect on all periods of the restatement and the correction to the third quarter of 2008 was to reduce net income by \$182,000 and diluted income per share by \$.03. For the three years ended October 31, 2007, the cumulative effect of the restatement was to increase net income by \$756,000 and to increase diluted income per share by \$.08. For the nine months ended July 31, 2008, the cumulative effect of the restatement and the correction to third quarter 2008 income was to reduce net income by \$938,000 and to reduce diluted income per share by \$.11. The restatement did not have any impact on any of the Company's financial covenants under its line of credit. The primary financial statement items impacted by this restatement are indicated below:

Table of Contents**Consolidated Statements of Operations**

	Nine Months Ended July 31, 2007		Three Months Ended July 31, 2007	
	As Previously Reported	Restated	As Previously Reported	Restated
Oil & Gas Sales	12,308,000	11,121,000	3,814,000	3,613,000
Total Revenues	12,993,000	11,806,000	4,047,000	3,846,000
Income from Operations	6,625,000	5,438,000	1,945,000	1,744,000
Realized Gains (Losses) from derivative contracts		1,187,000		201,000
Unrealized Gains (Losses) from derivative contracts		423,000		1,466,000
Income Before Taxes	6,625,000	7,048,000	1,945,000	3,411,000
Income Taxes	(1,888,000)	(2,010,000)	(554,000)	(964,000)
Net Income	4,737,000	5,038,000	1,391,000	2,447,000
Earnings per share -				
Basic	\$ 0.51	\$ 0.54	\$ 0.15	\$ 0.26
Diluted	\$ 0.50	\$ 0.54	\$ 0.15	\$ 0.26

Consolidated Statements of Cash Flows

	July 31, 2007	
	As Previously Reported	Restated
Cash Flows from Operating Activities		
Net Income	4,737,000	5,038,000
Unrealized gains on derivative contracts		(423,000)
Changes in operating assets and liabilities		
Other current assets	(281,000)	(158,000)

2. SIGNIFICANT ACCOUNTING POLICIES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The company bases its estimates on historical experience and on various other assumptions it believes to be reasonable under the circumstances. Although actual results may differ from these estimates under different assumptions or conditions, the company believes that its estimates are reasonable and that actual results will not vary significantly from the estimated amounts.

The company recognizes all derivatives as fair value hedges on its balance sheet at fair value at the end of each period. Changes in the fair value of hedges are now recorded in the Consolidated Statement of Operations

3.

STOCK-BASED COMPENSATION

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The CREDO Petroleum Corporation 2007 Stock Option Plan (the 2007 Plan) is described in the Notes to

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Consolidated Financial Statements in the company's Annual Report on Form 10-K/A for the year ended October 31, 2007. No options have been granted under the 2007 Plan. The CREDO Petroleum Corporation 1997 Stock Option Plan (the 1997 Plan) expired on July 29, 2007. No additional options can be granted under the 1997 Plan. However, all outstanding options granted under the 1997 Plan will continue to be governed by the terms of that Plan.

For the nine months ended July 31, 2008 and 2007, the company recognized stock based compensation expense of \$44,000 and \$138,000 respectively. For the three months ended July 31, 2008 and 2007, the company recognized compensation expense of \$14,000 and \$28,000, respectively. The estimated unrecognized compensation cost from unvested stock options as of July 31, 2008 was approximately \$79,000 which is expected to be recognized over an average of 2 years.

No options were granted during the nine months ended July 31, 2008 and the fair value of the 40,000 options granted during the nine months ended July 31, 2007 was estimated on the date of grant using a Black-Scholes option pricing model. The weighted average assumptions used in the option pricing model for the nine months ended July 31, 2007 were: volatility, 50.84%; expected option term, 2.5 years; risk-free interest rate, 4.58%; and expected dividend yield, 0%.

Plan activity for the nine months ended July 31, 2008 is set forth below:

	Nine Months Ended July 31, 2008		
	Number of Options	Weighted Average Exercise Price	Aggregate Intrinsic Value
Outstanding at October 31, 2007	270,251	\$ 6.94	642,000
Granted			
Exercised	(61,938)	5.93	407,000
Cancelled or forfeited			
Outstanding at July 31, 2008	208,313	\$ 7.25	490,000
Exercisable at July 31, 2008	186,697	\$ 6.60	599,000
Weighted average contractual life at July 31, 2008		5.54 years	
Weighted average market price at date of exercise for options exercised		\$ 12.50	

The following table summarizes information about stock options currently outstanding and exercisable at July 31, 2008:

Range of Exercise Prices	Number Outstanding at July 31, 2007	Outstanding Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Exercisable	
				Number Exercisable at July 31, 2008	Weighted Average Exercise Price
\$5.93	168,313	4.87	\$ 5.93	168,313	\$ 5.93
\$12.78	40,000	8.35	\$ 12.78	18,334	\$ 12.78

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\$5.93 - \$12.78

208,313

5.54

\$

7.25

186,647

\$

6.60

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4. NATURAL GAS PRICE HEDGING

On September 2, 2008, in connection with preparing its quarterly report for third quarter 2008, management of CREDO Petroleum Corporation (the company) and the Audit Committee of its Board of Directors determined that the contemporaneous formal documentation it had historically prepared to support its initial hedge designations in connection with the company's natural gas hedging program does not meet the technical requirements to qualify for cash flow hedge accounting treatment in accordance with SFAS 133. The primary reason for this determination was that the formal hedge documentation lacks specificity of the hedged items and therefore, the cash flow designations failed to meet hedge documentation requirements for cash flow hedge accounting treatment. Consequently, the unrealized gain or loss should have been recorded in the consolidated statements of operations as a component of income before income taxes. Under the cash flow accounting treatment used by the company, the fair values of the hedge contracts was recognized in the consolidated balance sheets with the resulting unrealized gain or loss, net of income taxes, recorded initially in accumulated other comprehensive income and later reclassified through earnings when the hedged production affected earnings.

The company periodically hedges the price of a portion of its estimated natural gas production when the potential for significant downward price movement is anticipated. Hedging transactions typically take the form of forward short positions and collars on the NYMEX futures market, and are closed by purchasing offsetting positions. Such hedges do not exceed estimated production volumes, are expected to have reasonable correlation between price movements in the futures market and the cash markets where the company's production is located, and are authorized by the company's Board of Directors. Hedges are expected to be closed as related production occurs but may be closed earlier if the anticipated downward price movement occurs or if the company believes that the potential for such movement has abated.

The company recognizes all derivatives as fair value hedges on its balance sheet at fair value at the end of each period. Changes in the fair value of hedges are now recorded in the Consolidated Statement of Operations.

Open hedge contracts are indexed to the NYMEX. Periodically, the company enters into contracts indexed to Panhandle Eastern Pipeline Company for Texas, Oklahoma mainline. For comparative purposes, hedges indexed to Panhandle Eastern Pipeline Company are expressed on a NYMEX basis. For hedges indexed to Panhandle Eastern Pipeline Company, the individual month price (basis) differentials between the NYMEX and Panhandle Eastern Pipeline Company range from minus \$1.45 in the winter months to minus \$0.90 in the spring months.

For the quarter ended July 31, 2008 the company has realized hedging losses of \$1,876,000 and unrealized hedging gains of \$3,015,000. Realized hedging gains were \$201,000 and unrealized hedging gains were \$1,466,000 for the same period in 2007.

For the nine months ended July 31, 2008 the company has realized hedging losses of \$1,024,000 and unrealized hedging losses of \$1,309,000. For the nine months ended July 31, 2007 the company had realized hedging gains of \$1,187,000 and unrealized gains of \$423,000.

The company has a hedging line of credit with its bank which is available, at the discretion of the company, to meet margin calls. To date, the company has not used this facility and maintains it only as a precaution related to possible margin calls. The maximum credit line is \$5,900,000 with interest calculated at the prime rate. The facility is unsecured and has covenants that require the company to maintain \$3,000,000 in cash or short term investments, none of which are required to be maintained at the company's bank, and prohibits funded debt in excess of \$500,000. It expires on November 15, 2010.

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The company's calculation of earnings per share of common stock is as follows:

	2008		Nine Months Ended July 31,		2007 (Restated)	
	Net Income	Shares	Net Income Per Share	Net Income	Shares	Net Income Per Share
Basic earnings per share	\$ 4,036,000	9,430,000	\$.43	\$ 5,038,000	9,268,000	\$.54
Effect of dilutive shares of common stock from stock options		79,000	(.01)		134,000	
Diluted earnings per share	\$ 4,036,000	9,509,000	\$.42	\$ 5,038,000	9,402,000	\$.54

	2008		Three Months Ended July 31,		2007 (Restated)	
	Net Income	Shares	Net Income Per Share	Net Income	Shares	Net Income Per Share
Basic earnings per share	\$ 3,343,000	9,690,000	\$.35	\$ 2,447,000	9,282,000	\$.26
Effect of dilutive shares of common stock from stock options		82,000	(.01)		124,000	
Diluted earnings per share	\$ 3,343,000	9,772,000	\$.34	\$ 2,447,000	9,406,000	\$.26

6. INCOME TAXES

The company uses the asset and liability method of accounting for deferred income taxes. Deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities. Deferred tax assets or liabilities at the end of each period are determined using the tax rate in effect at that time.

The total future deferred income tax liability is extremely complicated for any energy company to estimate due in part to the long-lived nature of depleting oil and gas reserves and variables such as product prices. Accordingly, the liability is subject to continual recalculation, revision of the numerous estimates required, and may change significantly in the event of such things as major acquisitions, divestitures, product price changes, changes in reserve estimates, changes in reserve lives, and changes in tax rates or tax laws.

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On November 1, 2007 the company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). In implementing FIN 48, we found no significant uncertain tax positions. Our policy is to recognize potential accrued interest and penalties related to unrecognized tax benefits in income tax expense, which is consistent with the recognition of these items in prior reporting periods. No interest and penalties related to uncertain tax positions were accrued at July 31, 2008.

We have not had any material changes to our unrecognized tax benefits since adoption, nor do we anticipate significant changes to the total amount of unrecognized tax benefits within the next twelve months.

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As of July 31, 2008 we remain subject to examination of our Federal and state tax returns, except Colorado, for the tax years 2004 through 2006, and for the tax years 2003 through 2006 for our Colorado tax returns.

7. COMMITMENTS AND CONTINGENCIES

The company has been named as a defendant in a lawsuit alleging breach of contract, and other issues, arising in the normal course of its oil and gas activities. The company believes that a contractual agreement requires that disputes be resolved by arbitration. Although the company believes the allegations are without merit and that the company will ultimately prevail, the ultimate outcome of this lawsuit, or arbitration, cannot be determined at this time.

The company has no material outstanding commitments at July 31, 2008.

8. STOCK SALE

During the quarter ended July 31, 2008 the company entered into, and closed, a Company Stock Purchase Agreement with RCH Energy Opportunity Fund II, LP (RCH). Under the terms of the agreement the company sold to RCH 1,150,000 shares of newly-issued common stock, par value \$0.10 at a price of \$14.50 per share, in cash. Transaction fees paid from the proceeds of sale were \$1,564,000.

Also under the terms of the agreement, RCH nominated, and the company's Board of Directors elected, two new directors to serve on the company's Board of Directors for so long as RCH beneficially owns at least 15% of the company's outstanding stock and one director for so long as RCH beneficially owns at least 10% of the company's outstanding stock.

The Purchase Agreement contains a standstill provision that prohibits RCH from acquiring any additional shares of the company's stock for a period of two years without the consent of the company.

In connection with the Company Stock Purchase Agreement with RCH the company amended its Rights Agreement, dated as of April 11, 1989, as amended, in order to exempt the Purchase Agreement from application of the Rights Agreement.

9. RECENT ACCOUNTING PRONOUNCEMENTS

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In November 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combination* (FAS 141(R)) and SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51* (FAS 160). FAS 141(R) will change how business acquisitions are accounted for and will impact financial statements both on the acquisition date and in subsequent periods. FAS 160 will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity. FAS 141(R) and FAS 160 are effective for both public and private companies for fiscal years beginning on or after December 15, 2008 (fiscal 2010 for the company). FAS 141(R) will be applied prospectively. FAS 160 requires retroactive adoption of the presentation and disclosure requirements for existing minority interests. All other requirements of FAS 160 will be applied prospectively. Early adoption is prohibited for both standards. Management is currently evaluating the requirements of FAS 141(R) and FAS 160 and has not yet determined the impact on its financial statements.

In December 2007, the FASB issued SFAS No. 157, *Fair Value Measurements*. This Statement does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. However, the application of this Statement may change how fair value is determined. The Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within

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those fiscal years. As of December 1, 2007 the FASB has proposed a one-year deferral for the implementation of the Statement for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. Management is currently evaluating the requirements of FAS 157 and has not yet determined the impact on its financial statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an Amendment to FASB Statement No. 133*. This statement expands the disclosures, and form of disclosures, that must be presented regarding derivatives and hedging activities. The Statement is effective for financial statements issued for fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. Management is currently evaluating the requirements of FAS 161 and has not yet determined the impact on its financial statements.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

EXPLANATORY NOTE

On September 2, 2008, in connection with preparing its quarterly report for third quarter 2008, management of CREDO Petroleum Corporation (the "company") and the Audit Committee of its Board of Directors determined that the contemporaneous formal documentation it had historically prepared to support its initial hedge designations in connection with the company's natural gas hedging program does not meet the technical requirements to qualify for cash flow hedge accounting treatment in accordance with SFAS 133. The primary reason for this determination was that the formal hedge documentation lacks specificity of the hedged items and therefore, the cash flow designations failed to meet hedge documentation requirements for cash flow hedge accounting treatment. Consequently, the unrealized gain or loss should have been recorded in the consolidated statements of operations as a component of income before income taxes. Under the cash flow accounting treatment used by the company, the fair values of the hedge contracts was recognized in the consolidated balance sheets with the resulting unrealized gain or loss, net of income taxes, recorded initially in accumulated other comprehensive income and later reclassified through earnings when the hedged production affected earnings.

The company will restate its consolidated financial statements for fiscal years ended October 31, 2005, 2006, 2007 and the first and second quarters of fiscal year ending October 31, 2008. There is no effect in any period on overall cash flows, EBITDA, total assets, total liabilities or total stockholders' equity. The restatement did not have any impact on any of the Company's financial covenants under its line of credit. Details of the effect of the restatement are indicated in Note 1 to the Consolidated Financial Statements.

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q includes certain statements that may be deemed to be "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements included in this Quarterly Report on Form 10-Q, other than statements of historical facts, address matters that the company reasonably expects, believes or anticipates will or may occur in the future. Forward-looking statements may relate to, among other things:

- the company's future financial position, including working capital and anticipated cash flow;

- amounts and nature of future capital expenditures;
- operating costs and other expenses;
- wells to be drilled or reworked;
- oil and natural gas prices and demand;
- existing fields, wells and prospects;
- diversification of exploration;

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- estimates of proved oil and natural gas reserves;
- reserve potential;
- development and drilling potential;
- expansion and other development trends in the oil and natural gas industry;
- the company's business strategy;
- production of oil and natural gas;
- matters related to the Calliope Gas Recovery System;
- effects of federal, state and local regulation;
- insurance coverage;
- employee relations;
- investment strategy and risk; and
- expansion and growth of the company's business and operations.

LIQUIDITY AND CAPITAL RESOURCES

At July 31, 2008, working capital increased \$13,920,000, or 103% to \$27,430,000 compared to \$13,510,000 at July 31, 2007. For the nine months ended July 31, 2008, net cash provided by operating activities increased \$1,392,000 to \$9,666,000 compared to net cash provided by operating activities of \$8,274,000 for the same period in 2007. Net income decreased \$1,002,000 primarily due to the recognition of unrealized hedging losses.

For the nine months ended July 31, 2008 and 2007, net cash used in investing activities was \$8,633,000 and \$6,421,000, respectively. Investing activities primarily included oil and gas exploration and development expenditures, including Calliope, totaling \$8,414,000 and \$6,794,000 respectively.

During the quarter ended July 31, 2008, the company sold 1,150,000 shares of newly issued \$.10 par value common stock. The sales price was \$14.50 per share, resulting in gross proceeds of \$16,675,000. Transaction fees of \$1,564,000 were paid from the proceeds. The company also purchased joint interest holders' rights to future Calliope installation revenues for \$975,000 with a portion of the proceeds.

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The average return on the company's investments for the nine months ended July 31, 2008 and 2007 was (3.0%) and 9.2%, respectively. At July 31, 2008, approximately 92% of the investments are in managed partnerships (generally known as hedge funds) that use various strategies to minimize their correlation to stock market movements. The remaining investments were directly invested in mutual funds. Most of the investments are highly liquid and the company believes they represent a responsible approach to cash management. In the company's opinion, the greatest investment risk is the potential for negative market impact from unexpected, major adverse news.

Existing working capital and anticipated cash flow are expected to be sufficient to fund operations and capital commitments for at least the next 12 months. At July 31, 2008, the company had no lines of credit or other bank financing arrangements except for the hedging line of credit discussed in Note 4. Because earnings are anticipated to be reinvested in operations, cash dividends are not expected to be paid. The company has no defined benefit plans and no obligations for post retirement employee benefits.

The company's adjusted earnings before unrealized gains/losses on derivative contracts, interest, taxes, depreciation, depletion and amortization, (EBITDA) increased to \$9,505,000 for the nine months ended July 31, 2008 from \$9,427,000 for the nine months ended July 31, 2007. EBITDA is not a GAAP measure of operating performance. The company uses this non-GAAP performance measure primarily to compare its performance with other companies in the industry that make a similar disclosure. The company believes that this performance measure may also be useful to investors for the same purpose. Investors should not consider this measure in isolation or as a substitute for operating income, or any other measure for determining the company's operating performance that is calculated in accordance with GAAP. In addition, because EBITDA is not a GAAP

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measure, it may not necessarily be comparable to similarly titled measures employed by other companies. A reconciliation between EBITDA and net income is provided in the table below:

	Nine Months Ended July 31,	
	2008	2007 (Restated)
RECONCILIATION OF EBITDA:		
Net Income	\$ 4,036,000	\$ 5,038,000
Add Back:		
Unrealized Gain (Loss) on Derivatives	1,309,000	(423,000)
Interest Expense	7,000	20,000
Income Tax Expense	1,559,000	2,010,000
Depreciation, Depletion and Amortization Expense	2,594,000	2,782,000
EBITDA	\$ 9,505,000	\$ 9,427,000

OFF-BALANCE SHEET FINANCING

The company has no significant off-balance sheet financing arrangements at July 31, 2008.

PRODUCT PRICES AND PRODUCTION

Although product prices are key to the company's ability to operate profitably and to budget capital expenditures, they are beyond the company's control and are difficult to predict. Since 1991, the company has periodically hedged the price of a portion of its estimated natural gas production when the potential for significant downward price movement is anticipated. Hedging transactions typically take the form of forward short positions, swaps and collars which are executed on the NYMEX futures market or by indexing to regional index prices associated with pipelines in proximity to the company's production. The company's current hedges are indexed to NYMEX. Refer to Note 4 of the Consolidated Financial Statements for a complete discussion on the company's hedging activities.

Gas and oil sales volume and price realization comparisons for the indicated periods are set forth below. Price realizations include the sales price and the effect of realized hedging transactions.

Product	2008	Nine Months Ended July 31,		2007	% Change	
		Volume	Price		Volume	Price
Gas (Mcf)	1,221,000	\$ 7.87(1)	1,517,000	\$ 6.72(2)	-19%	+17%
Oil (bbls)	42,500	\$ 101.66	37,200	\$ 56.52	+14%	+80%

2008	Three Months Ended July 31,	2007	% Change
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Product	Volume	Price	Volume	Price	Volume	Price
Gas (Mcf)	396,000	\$ 6.96(3)	494,000	\$ 6.21(4)	-20%	+12%
Oil (bbls)	13,400	\$ 122.91	12,100	\$ 62.36	+11%	+97%

(1) Includes \$0.32 per Mcf realized hedging loss.

(2) Includes \$0.77 per Mcf realized hedging gain.

(3) Includes \$3.13 per Mcf realized hedging loss.

(4) Includes \$0.41 per Mcf realized hedging gain.

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OPERATIONS

During the first three quarters of fiscal 2008, the company's operations continued to focus on its two core projects – natural gas drilling and application of its patented Calliope Gas Recovery System.

The company believes that, in combination, its drilling and Calliope projects provide an excellent (and possibly unique) balance for achieving its goal of adding long-lived natural gas reserves and production at reasonable costs and risks. However, it should be expected that successful results will occur unevenly for both the drilling and Calliope projects. Drilling results are dependent on both the timing of drilling and on the drilling success rate. Calliope results are primarily dependent on the timing, volume and quality of Calliope installations available to the company.

The company will continue to actively pursue adding reserves through its two core projects in fiscal 2008, and expects these activities to be a reliable source of reserve additions. However, the timing and extent of such activities can be dependent on many factors which are beyond the company's control, including but not limited to, the availability, cost and quality of oil field services such as drilling rigs, production equipment and related services, and access to wells for application of the company's patented gas recovery system on low pressure gas wells. The prevailing price of oil and natural gas has a significant effect on demand and, thus, the related cost of such services and wells.

The cost of field services, particularly the cost of drilling wells, has increased dramatically during the past several years, driven by higher energy prices. Concurrently, the quality of field services has diminished markedly due to manpower shortages. The combination of much higher field service costs and degradation in the quality of the services is having a materially negative impact on drilling economics. Accordingly, the company continues to high-grade its drilling prospects, and in some cases postpone less robust projects pending improvement in the field services sector. In the short term, this will reduce the number of drilling prospects which may, in turn, impede the growth of the company's production and reserves.

The company is currently experiencing delays in securing drilling rigs and delivery of production equipment, primarily compressors and coil tubing. These delays are extending the time it takes the company to conduct its field operations. As a result, the company could be at risk for price increases related to these types of services and equipment.

All of the company's oil and natural gas properties are located on-shore in the continental United States. The company's future drilling activities may not be successful, and its overall drilling success rate may change. Unsuccessful drilling activities could have a material adverse effect on the company's results of operations and financial condition. Also, the company may not be able to obtain the right to drill in areas where it believes there is significant potential for the company.

Drilling Activities.

Oklahoma and Texas Panhandle The company owns a significant inventory of acreage (approximately 70,000 gross acres)

located along the northern portion of the Anadarko Basin where it conducts an active drilling program. Wells generally target the Morrow, Oswego and Chester formations between 7,000 and 11,000 feet. The company expects to drill a substantial number of additional wells on this acreage.

In Hemphill County, Texas, the second well on the company's 3,780 gross acre Humphreys Prospect encountered sands in the Tonkawa and Cleveland formations that appear to be productive on electric logs. The vertical well has been completed in the Tonkawa sand and tested at good rates for both oil and gas. The well is currently waiting on pipeline connection. The company owns a 25% working interest.

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The company recently purchased interests in over 3,800 gross acres in Hemphill County and has taken over as operator of 11 wells. The new acreage complements the company's Humphreys Prospect and brings its total acreage in the area to approximately 8,300 gross acres.

In Oklahoma, three new wells are awaiting pipeline connection and six wells are scheduled for drilling. CREDO owns approximately 70,000 gross acres located primarily along the northern portion of the Anadarko Basin where it conducts an active drilling program. Wells generally target the Morrow, Oswego and Chester formations between 7,000 and 11,000 feet.

In Carter County, CREDO is waiting on rig arrival to drill a twin well to its Schaff #1 which has produced 235,000 barrels of oil. The Schaff well will become part of the Twin Forks Deese sand waterflood, and the new well will develop three oil sands that the Schaff well logs indicate are productive and which produce in the immediate area. CREDO owns a 41% working interest and is the operator.

In Major County, drilling is expected to commence shortly on the company's 1,280 gross acre Pool-Proffitt property. The 9,600-foot Lemmons #1-7 and Ball #1-18 wells will test a thick package of stacked carbonate zones. CREDO owns an approximate 70% working interest in the Lemmons and 50% of the Ball. Ultimately, the company expects to drill 10 to 12 wells on the prospect.

In Harper County, drilling will commence shortly on two wells located on the company's 3,840 gross acre Buffalo Creek Prospect where 11 wells have previously been completed for production. Both of the new wells will test the Chester formation at approximately 6,900 feet. CREDO owns working interests of 30% and 37% in the two wells.

In Southern Oklahoma, the company is participating in three waterflood projects as part of its overall strategy to improve the oil ratio in its reserve base. In Carter County, CREDO owns 17% of the Southeast Hewitt waterflood unit which has already produced 685,000 barrels of oil and is projected to ultimately produce about 1,200,000 barrels. The company also owns about 22% in Phase 1, and 12.3% in Phase 2, of a Twin Forks Deese sand waterflood unit that is being formed and is expected to produce about 1,000,000 barrels of oil. In Love County, CREDO owns 13% in Phase 1, and 9.5% in Phase 2, of the Eastman Hills waterflood unit that is expected to produce about 500,000 barrels of oil.

South Texas In South Texas, the initial test well on the Gemini Prospect resulted in a dry hole. The 17,000-foot well confirmed the seismic interpretation and found porous sand. However, the sand was water wet and the well was plugged and abandoned. CREDO received approximately \$1,300,000 of cash for the multiple prospect package and retained an 11.25% carried interest in the test well.

The prospect package consists of two additional Deep Wilcox prospects located to the north of Gemini Prospect. These two prospects are structurally different and unique compared to the Gemini Prospect. Those prospects are being further evaluated, and if drilled, CREDO will have the same 11.25% carried interest in the next well as it did in the Gemini Prospect test well.

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Elsewhere in South Texas, the company has recently purchased a 15.5% working interest in the Escobas Field. A major workover is underway on an existing well, and a new 15,500-foot Wilcox well has been drilled in which the company has a small carried interest. That well is currently producing 2.7 MMcfd (million cubic of gas per day) on a 12/64ths choke.

North-Central Kansas The company's Kansas acreage is located in prolific oil producing areas where 3-D seismic has proven effective in identifying undrilled structures. Drilling targets the Lansing-Kansas City and Arbuckle formations at about 4,000 feet, making the cost of drilling very inexpensive in relation to potential reserve value.

To date, 26 wells have been drilled on company acreage, of which 46% have been successful. Five of the

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12 successful wells had initial production rates of about 100 barrels of oil per day. Average proved reserves are estimated to be 50,000 to 55,000 barrels of oil per well. The company's first discovery in the play has already produced about 56,000 barrels of oil in 21 months and is still producing 75 barrels of oil per day. That well is expected to produce around 130,000 barrels of oil.

Since the company's last report, six wells have been drilled of which four are producers, yielding a 67% success rate. Six new wells are scheduled for the next few months, half of which will be on prospects where the company owns an 80% working interest.

Credo has acquired approximately 100,000 gross acres (35,000 net acres) located in prolific oil producing areas of the play and is continuing to expand its acreage position. The company currently owns interests ranging from 12.5% to 80% in 16 separate projects. Three dimensional (3-D) seismic has proven effective in identifying undrilled structures. Drilling targets the Lansing-Kansas City and Arbuckle formations at about 4,000 feet, making the cost of drilling moderate in relation to potential reserve value. Recent drilling successes have occurred primarily on prospects where the company owns smaller working interests.

Drilling success in this play is progressing well. In addition to providing good diversification to our other drilling activities, this project is 100% oil oriented and is expected to improve the balance between oil and natural gas in the company's reserve base.

Calliope Gas Recovery Technology.

The company owns the exclusive right to a patented technology known as the Calliope Gas Recovery System. There are currently three U.S. patents and two Canadian patents related to the technology. One additional patent that mirrors the U.S. patents has been applied for in Canada. Calliope systems are installed on wells located in Oklahoma, Texas and Louisiana.

Calliope can achieve substantially lower flowing bottom-hole pressure than other production methods because it does not rely on reservoir pressure to lift liquids. In many reservoirs, lower bottom-hole pressure can translate into recovery of substantial additional natural gas reserves.

Calliope has proven to be reliable and flexible over a wide range of applications on wells the company owns and operates. It has also proven to be consistently successful. Accordingly, the company is implementing strategies designed to expand the population of wells on which it can install Calliope.

Calliope's Track Record Calliope wells are located in Oklahoma, Texas, and Louisiana and produce from both sandstone and carbonate reservoirs, including the Chester, Cotton Valley, Edwards, Hart, Hunton, Morrow, Nodosaria, Redfork and Springer formations. The Calliope wells range in depth from 6,400 to 18,400 feet. These wells represent rigorous applications for Calliope because at the time Calliope was installed, 14 of the wells were dead (an average of two to

three years), nine were uneconomic and two were marginal. In addition, prior to the time Calliope was installed, many of the reservoirs were damaged by the parting shots of previous operators. Twenty-three of the wells were acquired from other operators after the operators had given-up on these wells. The previous operators were mostly medium to large independent oil and gas companies.

Initial Calliope production rates range up to 650 Mcfd and average per well Calliope reserves for non-experimental wells are estimated to be 1.0 Bcf. One of the company's early Calliope installations, the J.C. Carroll well, has now produced over a billion cubic feet of gas using Calliope.

The 25 Calliope installed applications are grouped into two categories - experimental wells and non-experimental wells, also referred to as go-forward applications. Eleven of the 25 wells are experimental applications and 14 are go-forward applications. Experimental wells generally represent the

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first experimental application of a Calliope configuration in a wellbore. For example, the first installation of Calliope inside a particular tubing size is classified as an experimental application.

Calliope has achieved compelling results on these less than ideal wells as is shown in the table below. For example, the entire group of 14 non-experimental wells were producing a total of only 88 Mcfd when Calliope was installed. Without Calliope, the wells represented a substantial plugging liability. However, with Calliope, those same 14 wells have now produced an incremental 3.4 Bcfe to date, and they are still producing about 2.0 MMcfed. With Calliope, the 14 wells were projected to have estimated ultimate incremental Calliope reserves totaling 13.6 Bcfe.

Group	No. of Wells	Average Calliope Reserves Per Well (Bcfe)	Total Calliope Production to Date (Bcfe)	Total Projected Calliope Reserves (Bcfe)
Non-Experimental Wells	14	1.0	3.4	13.6
Experimental Wells	11	0.2	0.6	1.4
All Wells	25	0.6	4.0	15.0

Calliope has proven to be a low risk and low cost liquid lift technology. Calliope has never failed to lift the liquids out of a wellbore. The average cost of a Calliope system is \$400,000 for a 12,000-foot application. Based on average per well Calliope reserves of 1.0 Bcfe for go-forward applications, cost of Calliope in terms of units of natural gas reserves added is low compared to industry averages. Based on current natural gas prices, Calliope can economically be installed on wells which will yield significantly less than 1.0 Bcf of Calliope reserves. This will enable the company to significantly expand the range of Calliope applications to include many low permeability reservoirs, possibly including those in shale and other resource plays.

Realizing Calliope's value continues to be one of the company's top priorities. The company has been focused on three fronts to increase the number of Calliope installations: expanding the geographic region for purchasing Calliope candidate wells from third parties, joint ventures with larger companies, and drilling wells into low-pressure gas reservoirs for the purpose of using Calliope to recover stranded natural gas reserves.

Purchasing Calliope Candidate Wells Calliope operations were expanded into Texas and Louisiana in fiscal 2006. The company considers Texas and Louisiana to be very fertile areas for Calliope and has retained personnel and opened a Houston office to focus exclusively on purchasing wells for Calliope and on Calliope joint ventures.

In general, higher natural gas prices have made it increasingly difficult for the company to purchase wells for its Calliope system. In addition, higher gas prices have provided the incentive for other companies to perform high risk procedures (parting shots) in an attempt to revive wells prior to abandoning or selling the wells. These parting shots often result in severe reservoir damage that renders wells unsuitable for Calliope. Accordingly, viable Calliope candidate wells available to be purchased by the company have been very restricted.

Joint Ventures With Third Parties In an effort to increase the number of Calliope installations, the company has been discussing joint ventures with larger companies. Presentations have been made to a select group of companies, including majors and large independents. All of the companies have expressed an interest in Calliope. Two joint venture agreements were completed during 2007.

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Joint venture discussions are in progress with a number of the companies, including evaluation of candidate wells. The joint venture negotiation process has taken longer than expected because there are many decision points within large companies that cause delays. Nevertheless, the company continues to dedicate substantial resources to joint venture projects because it believes joint venturing holds substantial promise for Calliope.

Calliope Drilling Project The company believes that there is a huge amount of gas stranded in abandoned and low pressure reservoirs that can be recovered using Calliope. It believes drilling new wells for Calliope into such reservoirs will provide a repeatable opportunity to lease large areas for systematic re-development. In addition, new wells allow optimum casing and tubular sizes to be installed which will substantially improve reserves and production compared to installing Calliope on existing wells where undersized tubulars often restrict Calliope's optimum performance.

In June 2007, the company entered into a joint venture to purchase an 11,000-foot well located in East Texas. The previous operator drilled the well and encountered low reservoir p