CREDO PETROLEUM CORP
Form 10-K
January 17, 2012
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# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

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# FORM 10-K

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

**For The Fiscal Year Ended October 31, 2011**

**or**

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

**For the transition period from to**

**Commission File Number 0-8877**

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# CREDO PETROLEUM CORPORATION

(Exact name of registrant as specified in its charter)

| **Delaware** | **84-0772991** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification Number) |

**1801 Broadway, Suite 900, Denver, Colorado 80202-3837**

(Address of principal executive offices and zip code)

Registrant s telephone number, including area code: **(303) 297-2200**

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act:

**Common Stock, $.10 Par Value**

(Title of class and shares outstanding)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act: o Yes x No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act: o Yes x No

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. x Yes o No

Indicate by checkmark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 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). x Yes o No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (S229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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 definition of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

| Large accelerated filer o | Accelerated filer x |
|---|---|
| Non-accelerated filer o | Smaller reporting company o |

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates as of April 30, 2011, the end of the registrant s most recently completed second quarter was $81,621,000.

As of January 4, 2012, the registrant had 10,041,000 shares of common stock outstanding.

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## DOCUMENTS INCORPORATED BY REFERENCE

Pursuant to instruction G (3) to Form 10-K, Items 10, 11, 12, 13 and 14 are omitted because the Company will file a definitive proxy statement (the Proxy Statement ) pursuant to Regulation 14A under the Securities Exchange Act of 1934 not later than 120 days after the end of the fiscal year. The information required by such items will be included in the Proxy Statement to be so filed for the Company s annual meeting of shareholders to be held on or about April 5, 2012 and is hereby incorporated by reference.

## NON-GAAP FINANCIAL MEASURES

In this Annual Report on Form 10-K, the Company uses the term EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization including impairment losses) which is considered a non-GAAP financial measure as defined in SEC Regulation S-K Item 10 and should not be considered in isolation or as a substitute for measures of performance prepared in accordance with GAAP. See Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations for a definition of this measure as used in this Annual Report on Form 10-K.

Estimated Future Net Revenues Discounted at 10% is not a GAAP measure of operating performance. This pre-tax, non-GAAP measure is used by the Company in connection with estimating funds expected to be available in the future for drilling and other operating activities. See Item 2 PROPERTIES, Significant Properties, Estimated Proved Oil and Gas Reserves, and Future Net Revenues for a reconciliation of Estimated Future Net Revenues Discounted at 10% to the Standardized Measure of Discounted Future Net Cash Flows as shown in Note 13 to the Company s Consolidated Financial Statements.

## FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K 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 Annual Report on Form 10-K, 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 include, among other things, statements relating to:

- the Company s future financial position, including working capital and anticipated cash flow;
- amounts and nature of future capital expenditures;
- projections of operating costs and other expenses;
- wells to be drilled or reworked including new drilling expectations;
- expectations regarding oil and natural gas prices and demand;
- existing fields, wells and prospects;

- diversification of exploration, capital exposure, risk and reserve potential of drilling activities;
- estimates of proved oil and natural gas reserves;
- expectations and projections regarding joint ventures;
- reserve potential;
- development and drilling potential;
- expansion and other development trends in the oil and natural gas industry;
- the Company s business strategy;
- production and production potential of oil and natural gas;
- matters related to the Calliope Gas Recovery System, including projections for future use of Calliope and the success of Calliope;
- effects of federal, state and local regulation;
- adequacy of insurance coverage;
- employee relations;
- investment strategy and risk; and
- expansion and growth of the Company s business and operations.

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Although the Company believes that the expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations will prove to be correct. Disclosure of important factors that could cause actual results to differ materially from the Company s expectations, or cautionary statements, are included under Risk Factors and elsewhere in this Annual Report on Form 10-K, including, without limitation, in conjunction with the forward-looking statements. The following factors, among others that could cause actual results to differ materially from the Company s expectations, include:

- unexpected changes in business or economic conditions;
- significant changes in natural gas and oil prices;
- timing and amount of production;
- unanticipated down-hole mechanical problems in wells or problems related to producing reservoirs or infrastructure;
- changes in overhead costs;
- material events resulting in changes in estimates; and
- competitive factors.

All forward-looking statements speak only as of the date made. All subsequent written and oral forward-looking statements attributable to the Company, or persons acting on the Company s behalf, are expressly qualified in their entirety by the cautionary statements. Except as required by law, the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which it is made or to reflect the occurrence of anticipated or unanticipated events or circumstances.

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## PART I

## ITEM 1. BUSINESS

### General

Credo Petroleum Corporation ( Credo ) was incorporated in Colorado in 1978 and reincorporated in Delaware in 2009. Credo and its wholly owned subsidiaries, SECO Energy Corporation and United Oil Corporation ( SECO , United and collectively the Company ), are headquartered in Denver, Colorado. The Company is engaged in the exploration for and the acquisition, development and marketing of crude oil and natural gas in the Mid-Continent and Rocky Mountain regions and is currently conducting oil-focused drilling projects in North Dakota Bakken and Three Forks, Kansas, Nebraska and Texas Panhandle plays. Credo uses advanced technologies to systematically explore for oil and gas and, through its patented Calliope Gas Recovery System, to recover stranded reserves from depleted gas reservoirs. Credo is an active operator in Kansas, Nebraska, Wyoming, Colorado and Texas. United is an active operator doing business primarily in Oklahoma, and SECO primarily owns royalty interests in the Rocky Mountain region. The Company has operating activities in nine states and has 15 employees. References to years as used in this report indicate fiscal years ended October 31.

### Business Activities

Credo is engaged in the exploration for, acquisition of, and production of crude oil, natural gas and natural gas liquids. As used in the Form 10-K, the term oil or crude oil refers to both crude oil and natural gas liquids. The Company acts as the operator of approximately 108 wells pursuant to standard industry operating agreements. The Company owns working interests in about 337 producing wells and overriding royalty interests in about 1,200 wells.

In recent years, the Company has made significant strategic changes with the objective of transitioning its production and reserves from virtually all natural gas to being primarily oil. This strategic decision was made because the Company believes that oil will continue to maintain a significant Btu price premium over U.S. sourced natural gas. To accomplish this objective, the Company implemented new conventional exploration projects in Kansas and Nebraska, and new horizontal exploration prospects in the North Dakota Bakken and Three Forks shale-oil play and the Texas Panhandle. These strategic changes are also intended to diversify the Company s drilling projects both geographically and scientifically. Refer to the Certain Significant Effects of the Company s Strategic Transition from Oil to Natural Gas section of Item 7, Management Discussion and Analysis, for further information regarding these strategic changes.

The Bakken and Three Forks play involves horizontal drilling where wells are typically drilled to a measured depth of about 20,000 feet (10,000 feet vertical and 10,000 feet horizontal). Individual wells currently cost about $10,000,000. The Company expects virtually all of its Bakken and Three Forks wells to be completed as producers. Drilling in Kansas and Nebraska is conventional vertical drilling mostly for the Lansing Kansas City formation at 4,000 to 5,000 feet. Completed wells cost about $450,000. The Kansas and Nebraska play is primarily exploratory and the Company s current success rate ranges between 40% and 45%. At current oil prices, the risk adjusted economics for both plays are very good.

Prior to 2008, the Company s core drilling region was the northern shelf of the Anadarko Basin in Oklahoma where it explored primarily for natural gas. As a result, the Company s production and reserves have historically been heavily weighted in favor of natural gas. However, at the end of fiscal 2011, the Company has achieved relative balance between oil and natural gas in both its production and reserves. It is the Company s intent to focus almost exclusively on drilling for oil in order to continue to increase the percentage of oil in both its production and reserves. Depending on natural gas prices, the Company will again generate prospects and conduct drilling on its core natural gas-prone acreage in Oklahoma, concentrating on medium depth properties.

The Company also owns the patents covering its Calliope Gas Recovery System ( Calliope ). Calliope efficiently lifts fluids from wellbores using pressure differentials, thus allowing gas previously trapped by fluid build-up in the wellbore to flow to the surface. Calliope is distinguished from other fluid lift technologies because it does not rely on bottom-hole pressure

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and has only one down-hole moving part.  Calliope is primarily applicable to mature natural gas wells in low pressure, natural gas expansion reservoirs at depths below 8,000 feet.  The Company has proven Calliope s economic viability and flexibility over a wide range of applications.  Calliope s low per-unit finding and production costs have become increasingly attractive as the economics on many gas drilling projects have deteriorated due to low natural gas prices.  The Company also believes that lower natural gas prices may stimulate divestitures of marginal properties by other companies, including properties that have Calliope potential

For additional information, refer to Item 2, Properties and to the Drilling Activities section of Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations , (hereinafter referred to as MD&A ).

**Markets and Customers**

Marketing of the Company s oil and gas production is influenced by many factors which are beyond the Company s control, and the exact effect of which cannot be accurately predicted. These factors include changes in supply and demand, speculation, market prices, regulation, and actions of major foreign producers.

Oil price fluctuations can be extremely volatile as has been demonstrated during the past five years when NYMEX prices have ranged from $35 to over $140 per barrel.  Oil prices on the NYMEX have recently fluctuated between $75 and $105 per barrel.  Oil production is generally sold to crude oil purchasing companies pursuant to one year contracts at competitive market prices for the area. Crude oil and condensate production are readily marketable, and the Company is generally not dependent on a single purchaser.  Absent wars and other events of conflict, crude oil prices are mostly subject to world-wide supply and demand and are primarily dependent upon available supplies, which can vary significantly depending on production and pricing policies of OPEC and other major producing countries.  In recent years, U.S. Mid-Continent oil prices have been affected by increasing supplies from Bakken shale-oil development and from Canada which have resulted in high inventories and bottlenecks at the Cushing Oklahoma NYMEX hub.

The active U.S. spot market for natural gas, changes in supply and demand for natural gas, speculation, and weather patterns cause natural gas prices to be subject to significant fluctuations.  The Company presently sells virtually all of its natural gas pursuant to three to five year contracts with major pipeline companies.  The sales price is typically based on monthly index prices for the applicable pipeline.  Title to the natural gas normally passes to the pipeline at meters located near the wells.  The index prices are reduced by certain pipeline charges.

Most of the Company s natural gas production is located in northwestern Oklahoma.  There has been significant consolidation among natural gas pipelines in this area, thereby reducing the number of available purchasers.  In many instances, there may be only one viable pipeline option, which enables the pipeline to charge higher rates.

The economic downturn that commenced in the second half of 2008 resulted in a significant reduction in industrial demand for natural gas at the same time gas supplies were significantly increasing due to horizontal drilling success in shale-gas plays.  Those events caused an over supply of natural gas with the result that natural gas prices have remained depressed through 2011.  The Company expects U.S. natural gas supplies to continue to be ample for the foreseeable future but cannot reasonably predict the extent or timing of natural gas price fluctuations.

As discussed in Note (5) to the Consolidated Financial Statement, the Company periodically hedges the price of a portion of its estimated production based primarily on NYMEX futures prices using forward short positions and costless collars.  Information concerning the Company s major customers is included in Note (12) to the Consolidated Financial Statements.

**Competition and Regulation**

The oil and gas industry is highly competitive.  As a small independent, the Company must compete against companies with substantially greater financial, human and other resources in all aspects of its business.

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Oil and gas drilling and production operations are regulated by various federal, state and local agencies. These agencies issue binding rules and regulations which carry penalties, often substantial, for failure to comply. The Company anticipates its aggregate burden of federal, state and local regulation will continue to increase, particularly in the area of rapidly changing environmental laws and regulations. The Company also believes that its present operations substantially comply with applicable regulations. There are no known environmental or other regulatory matters related to the Company s operations which are reasonably expected to result in material liability to the Company. The Company believes that capital expenditures related to environmental control facilities or other regulatory matters will not be material in 2012. The Company cannot predict what subsequent legislation or regulations may be enacted or what effect they might have on the Company s business.

## ITEM 1A. RISK FACTORS

In evaluating the Company, careful consideration should be given to the following risk factors, in addition to the other information included or incorporated by reference in this Annual Report on Form 10-K. Each of these risk factors could adversely affect the Company s business, operating results and financial condition, as well as adversely affect the value of an investment in the Company s common stock.

**Volatility of oil and natural gas prices could adversely affect the Company s profitability and financial condition.**

The Company s performance in terms of revenues, operating results, profitability, future rate of growth, the value of its reserves and the carrying value of its oil and natural gas properties is significantly impacted by prevailing market prices for oil and natural gas. Any substantial or extended decline in the price of oil or natural gas could have a material adverse effect on the Company. It could reduce the Company s operating cash flow as well as the value and, to a lesser degree, the quantity of its oil and natural gas reserves.

Historically, the markets for oil and natural gas have been volatile, and they are likely to continue to be volatile. Relatively minor changes in supply or demand can have a significant effect on oil and natural gas prices. Some of the factors affecting oil and natural gas prices which are beyond the Company s control include:

- worldwide and domestic supplies of oil and natural gas;
- worldwide and domestic demand for oil and natural gas;
- the ability of the members of OPEC to agree to and maintain oil price and production controls;
- political instability or armed conflict in oil or natural gas producing regions;
- worldwide and domestic economic conditions;
- the availability of transportation facilities;
- weather patterns; and
- actions of governmental authorities.

**Competition for opportunities to replace and increase production and reserves is intense and could adversely affect the Company.**

Properties produce at a declining rate over time. In order to maintain its current production rates, the Company must add new oil and natural gas reserves to replace those being depleted by production. Competition within the oil and natural gas industry is intense and many of the Company s competitors have financial and other resources substantially greater than those available to the Company. This could place the Company at a disadvantage with respect to accessing opportunities to maintain, or increase, its oil and natural gas reserve base.

**The Company will utilize debt financing for partial funding of its 2012 drilling and exploration program.**

For the first time in the Company s history, financing is expected to be required to fund a portion of the Company s fiscal 2012 drilling budget. The Company has approved a drilling budget of $30,000,000 for fiscal 2012, which is about double last year s drilling budget. Two thirds of the

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2012 drilling budget is earmarked for drilling in the Bakken and Three Forks project. Subsequent to fiscal 2011 year end, the Company has entered into an oil and gas reserves borrowing base revolving credit line with its principal bank. The initial borrowing base is $7 million but may be extended twice a year. Borrowing in 2012 is expected to range from $7 million to $12 million. The financing agreement is pending final execution of the paperwork. In future years, the Company reasonably expects that additional financing, either debt or equity, will be required. See additional information below regarding uncertainties related to the timing and costs of Bakken and Three Forks drilling due to the Company being a non-operator, and additional information below regarding projected capital expenditures and capital requirements. See Note 6 to the Consolidated Financial Statements for further information regarding debt financing.

Future cash flows and the availability of financing are subject to a number of variables, such as:

- the Company s success in locating and producing new reserves;
- the level of reserves and production related to existing wells;
- the prices of oil and natural gas; and
- the terms of available financing.

Issuing equity securities to satisfy the Company s cash flow needs could cause substantial dilution to existing stockholders. Debt financing may make the Company more vulnerable to competitive pressures and economic downturns.

**The Company is a non-operator in the North Dakota Bakken and Three Forks oil-shale play.**

The Company is not the operator for its Bakken and Three Forks acreage and is, therefore, not in control of the timing and amount of expenditures. Larger companies with more experience drilling and operating Bakken and Three Forks wells are the operators of the spacing units which include the Company s leases because such companies generally own the majority (or a very large interest) in the spacing unit. The primary advantages to the Company are as follows: (i) the larger companies have much larger staffs than the Company which include people who specialize in many of the individual technical aspects of horizontal Bakken and Three Forks drilling and operations, and (ii) the larger companies generally operate many wells in the Bakken and Three Forks play and thus have the ability to compete for oil field services and product markets more effectively than the Company. The primary disadvantage of the Company being a non-operator in the Bakken and Three Forks play is that the Company is not in control of timing of drilling operations or the costs of drilling and operating the wells, and therefore, cannot reasonably predict such timing and costs until well proposals are received from the operators.

**In the event the Company does not meet its plan for future Calliope installations, it may be required to record an impairment of the asset.**

The patents underlying Calliope are carried as a non-current asset on the Company s balance sheet and are being amortized over the average remaining life of the patents. The Company periodically evaluates this asset for realizability. The Company believes that the number of future

installations will be sufficient to demonstrate recoverability of the cost. If the Company is unable to achieve the expected level of installations, it may in the future be required to record an impairment of the asset. Any such write-down would be a non-cash charge to income and would have no effect on working capital.

**Reserve quantities and values are subject to many variables and estimates and actual results may vary.**

This Annual Report on Form 10-K contains estimates of the Company s proved oil and natural gas reserves and the estimated future net revenues from those reserves. A significant negative variance in these estimates could have a material adverse effect on the Company s future performance.

Reserve estimates are based on various assumptions, including assumptions required by the SEC relating to oil and natural gas prices, drilling and operating expenses, capital expenditures, taxes and availability of funds. The process of estimating reserves is complex. This process

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requires significant decisions and assumptions related to the evaluation of available geological, geophysical, engineering and economic data.

Reserve estimates are dependent on many variables, many of which are beyond the Company s control. Therefore, as more information becomes available, it is reasonable to expect actual future production, oil and natural gas prices, revenues, taxes, development expenditures , operating expenses and quantities of recoverable oil and natural gas reserves will vary from the estimates, including the timing of expenditures and revenue receipts. Any significant variance could materially affect the estimated quantities and the present value of reserves disclosed by the Company. Reserve estimates and valuations will be adjusted in the future as more information becomes available.

As of October 31, 2011, approximately 51% of the Company s estimated proved reserves are classified as proved undeveloped. Estimation of proved undeveloped reserves and proved developed non-producing reserves is generally based on volumetric calculations rather than the performance data used to estimate reserves for producing properties. Recovery of proved undeveloped reserves generally requires significant capital expenditures and successful drilling operations. Revenues from proved developed non-producing and proved undeveloped reserves will not be realized until the related wells are drilled. The reserve estimate includes an estimate of the capital expenditures required to develop these reserves as well as the timing of such expenditures. Although the Company s independent engineers have prepared estimates of its proved undeveloped reserves and the associated development costs in accordance with industry standards, actual results are likely to vary from those estimates.

You should not interpret the present value of estimated reserves, or PV-10, as the current market value of reserves attributable to the Company s properties. The 10% discount factor, which we are required to use to calculate PV-10 for reporting purposes, is not necessarily the most appropriate discount factor given actual interest rates and risks to which the Company s business or the oil and natural gas industry in general are subject. The Company is also required to base the PV-10 on average prices it receives on the first day of each of the preceding twelve months and costs as of the date of the reserve estimate. Actual future prices and costs may be materially higher or lower. In addition to the price volatility factors discussed above, the following factors, among others, will affect actual future net cash flows, include:

- the amount and timing of actual production;
- curtailments or increases in consumption by oil and natural gas purchasers; and
- changes in governmental regulations or taxation.

As a result, the Company s actual future net cash flows could be materially different from the estimates included in this Annual Report on Form 10-K.

**Full cost pool ceiling subject to reserve values.**

The Company uses the full cost method of accounting for costs related to its oil and natural gas properties. Capitalized costs included in the full cost pool are depreciated and depleted on an aggregate basis using the units-of-production method.

Both the volume of proved reserves and any estimated future expenditures used for the depreciation and depletion calculation are based on estimates such as those described under Oil and Gas Reserves .

The capitalized costs in the full cost pool are subject to a quarterly ceiling test that limits such pooled costs to the aggregate of the present value of future net revenues attributable to proved oil and natural gas reserves discounted at 10% plus the lower of cost or market value of unproved properties less any associated tax effects. If such capitalized costs exceed the ceiling, the Company will record a write-down to the extent of such excess as a non-cash charge to earnings. Any such write-down will reduce earnings in the period of occurrence and result in lower depreciation and depletion in future periods. A write-down may not be reversed in future periods, even though higher oil and natural gas prices may subsequently increase the ceiling.

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**The Company s reserve quantities and values are concentrated in a relative few properties and fields.**

The Company s reserves, and reserve values, are concentrated in 79 properties which represent 23% of the Company s total properties but a disproportionate 80% of the discounted value (at 10%) of the Company s reserves. Reserves related to new wells, including wells in the proved developed non-producing and proved undeveloped categories, comprise 27% of significant properties and 30% of the discounted value of significant properties. Due to limited or no production history, reserve estimates for those categories are based primarily on volumetric estimates which are subject to significant change as more data becomes available.

**Competition for materials and services is intense and could adversely affect the Company.**

Major oil companies, independent producers, and institutional and individual investors are actively seeking oil and gas properties throughout the world, along with the equipment, labor and materials required to develop and operate properties. Shortages of equipment, labor or materials may result in increased costs or the inability to obtain such resources as needed. Many of the Company s competitors have financial and technological resources which exceed those available to the Company.

**Oil and natural gas short sale and collar derivatives involve credit risk and place an upper limit on future revenues from price increases.**

To manage the Company s exposure to price risks associated with the sale of oil and natural gas, the Company periodically enters into derivative hedging transactions for a portion of its estimated production. While such transactions limit the Company s exposure to price decreases, they also place an upper limit on the Company s potential gains if product prices were to rise over the price established by the derivatives. In addition, such transactions could expose the Company to the risk of financial loss in certain circumstances, including instances in which:

- the Company s production is less than the estimated amount that is hedged;
- the contractual counterparties fail to perform under the contracts; or
- a sudden, unexpected event materially impacts product prices.

The terms of the Company s derivative agreements may also require that it furnish cash collateral, letters of credit or other forms of performance assurance in the event that mark-to-market calculations result in settlement obligations by the Company. In such event, the Company has the option to obtain funding through its financing agreement.

The Company s natural gas derivatives are generally based on NYMEX prices but the Company s hedged natural gas production is primarily sold on a regional pipeline index price. The regional price is currently about 5% below NYMEX prices. Regional weather conditions and other economic factors can frequently result in substantially higher basis differentials. Oil derivatives generally are in the form of costless collars or

forward short positions and are also generally based on NYMEX pricing.

The Company has elected not to designate its commodity derivatives as cash flow hedges for accounting purposes. Accordingly, such contracts are recorded at fair value on its Balance Sheets and changes in fair value are recorded in the Statements of Operations as they occur.

**The marketability of the Company s natural gas production is dependent upon infrastructure, such as gathering systems, pipelines and processing facilities, that the Company does not own or control.**

The marketability of the Company s natural gas production depends in part upon the availability, proximity and capacity of natural gas pipelines and processing facilities necessary to move the Company s natural gas production to market. The Company does not own this infrastructure and is dependent on other companies to provide it.

**Oil and natural gas operations are inherently risky.**

The oil and natural gas business involves a variety of risks, including the risks of operating hazards such as fires, explosions, cratering, blow-outs, and encountering formations with abnormal

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pressures. The occurrence of any of these risks could result in losses. The Company maintains insurance against some, but not all, of these risks. The occurrence of a significant event that is not fully insured could have a material adverse effect on the Company s financial position and results of operations.

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.

The Company has recently expanded the volume and breadth of its exploration program with new drilling projects in North Dakota, Kansas and Nebraska, and the Texas Panhandle. Compared to the Company s conventional drilling, the Texas Panhandle and North Dakota horizontal drilling projects are substantially more expensive to lease, drill and operate.

**The Company s operations are subject to a variety of regulatory constraints.**