

CONTANGO OIL & GAS CO  
Form 10-Q  
November 08, 2006  
Table of Contents

---

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**FORM 10-Q**

---

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from            to

Commission file number 001-16317

---

**CONTANGO OIL & GAS COMPANY**

(Exact name of registrant as specified in its charter)

---

**DELAWARE**  
(State or other jurisdiction of  
incorporation or organization)

**3700 BUFFALO SPEEDWAY, SUITE 960**

**HOUSTON, TEXAS 77098**

**95-4079863**  
(IRS Employer

Identification No.)

Edgar Filing: CONTANGO OIL & GAS CO - Form 10-Q

(Address of principal executive offices)

(713) 960-1901

(Registrant's telephone number, including area code)

---

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The total number of shares of common stock, par value \$0.04 per share, outstanding as of November 3, 2006 was 15,019,835.

---

**Table of Contents**

**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**  
**QUARTERLY REPORT ON FORM 10-Q**  
**FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2006**

**TABLE OF CONTENTS**

	<b>Page</b>
<b>PART I FINANCIAL INFORMATION</b>	
Item 1. Consolidated Financial Statements	
<u>Consolidated Balance Sheets as of September 30, 2006 and June 30, 2006</u>	3
<u>Consolidated Statements of Operations for the three months ended September 30, 2006 and 2005</u>	5
<u>Consolidated Statements of Cash Flows for the three months ended September 30, 2006 and 2005</u>	6
<u>Consolidated Statement of Shareholders' Equity for the three months ended September 30, 2006</u>	7
<u>Notes to the Consolidated Financial Statements</u>	8
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	18
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	48
<u>Item 4. Controls and Procedures</u>	48

**PART II OTHER INFORMATION**

<u>Item 1A. Risk Factors</u>	49
<u>Item 6. Exhibits and Reports on Form 8-K</u>	49

*All references in this Form 10-Q to the Company, Contango, we, us or our are to Contango Oil & Gas Company and its wholly-owned Subsidiaries. Unless otherwise noted, all information in this Form 10-Q relating to natural gas and oil reserves and the estimated future net cash flows attributable to those reserves are based on estimates prepared by independent engineers and are net to our interest.*

**Table of Contents****CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

<b>ASSETS</b>	<b>September 30, 2006 (Unaudited)</b>	<b>June 30, 2006</b>
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 3,650,634	\$ 10,274,950
Short-term investments, at market	9,011,650	18,472,327
Accounts Receivable:		
Trade receivables	646,266	481,593
Advances to related parties	1,153,061	256,180
Joint interest billings receivable	6,800,600	3,422,261
Inventory tubulars	334,797	194,825
Prepaid capital costs	3,702,318	1,208,299
Other	389,043	202,583
<b>Total current assets</b>	<b>25,688,369</b>	<b>34,513,018</b>
<b>PROPERTY AND EQUIPMENT:</b>		
Natural gas and oil properties, successful efforts method of accounting:		
Proved properties	34,724,637	18,395,015
Unproved properties	22,901,145	23,293,300
Furniture and equipment	231,877	231,877
Accumulated depreciation, depletion and amortization	(837,937)	(662,877)
<b>Total property and equipment, net</b>	<b>57,019,722</b>	<b>41,257,315</b>
<b>OTHER ASSETS:</b>		
Cash and other assets held by affiliates	762,069	1,054,100
Investment in Freeport LNG Project	3,243,585	3,243,585
Investment in Contango Venture Capital Corporation	5,137,419	4,453,028
Deferred income tax asset	4,717,310	4,455,190
Facility fees and other assets	372,147	408,769
<b>Total other assets</b>	<b>14,232,530</b>	<b>13,614,672</b>
<b>TOTAL ASSETS</b>	<b>\$ 96,940,621</b>	<b>\$ 89,385,005</b>

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

**Table of Contents****CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>September 30, 2006 (Unaudited)</b>	<b>June 30, 2006</b>
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 7,352,472	\$ 1,041,505
Joint interest advances	6,800,522	5,638,600
Accrued exploration and development	8,503,294	8,278,245
Advances from related parties	780,153	194,862
Other accrued liabilities	628,334	1,026,743
<b>Total current liabilities</b>	<b>24,064,775</b>	<b>16,179,955</b>
<b>LONG-TERM DEBT</b>	<b>10,000,000</b>	<b>10,000,000</b>
<b>ASSET RETIREMENT OBLIGATION</b>	<b>665,458</b>	<b>665,458</b>
<b>SHAREHOLDERS EQUITY:</b>		
Convertible preferred stock, 6%, Series D, \$0.04 par value, 4,000 shares authorized, 2,000 shares issued and outstanding at September 30, 2006 and June 30, 2006, liquidation preference of \$10,000,000 at \$5,000 per share	80	80
Common stock, \$0.04 par value, 50,000,000 shares authorized, 17,590,835 shares issued and 15,015,835 outstanding at September 30, 2006, 17,574,085 shares issued and 14,999,085 outstanding at June 30, 2006,	703,631	702,961
Additional paid-in capital	45,181,486	45,105,504
Treasury stock at cost (2,575,000 shares)	(6,180,000)	(6,180,000)
Retained earnings	22,505,191	22,911,047
<b>Total shareholders equity</b>	<b>62,210,388</b>	<b>62,539,592</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>\$ 96,940,621</b>	<b>\$ 89,385,005</b>

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

**Table of Contents****CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>REVENUES:</b>		
Natural gas and oil sales	\$ 1,192,306	\$ 147,778
<b>Total revenues</b>	<b>1,192,306</b>	<b>147,778</b>
<b>EXPENSES:</b>		
Operating expenses	132,949	5,749
Exploration expenses	401,347	339,438
Depreciation, depletion and amortization	212,191	55,360
General and administrative expenses	1,103,342	922,263
<b>Total expenses</b>	<b>1,849,829</b>	<b>1,322,810</b>
<b>LOSS FROM CONTINUING OPERATIONS BEFORE OTHER INCOME AND INCOME TAXES</b>	<b>(657,523)</b>	<b>(1,175,032)</b>
Interest expense (net of interest capitalized)	(167,471)	(96)
Interest income	251,659	209,053
Other income	84,391	209,522
<b>LOSS FROM CONTINUING OPERATIONS BEFORE INCOME TAXES</b>	<b>(488,944)</b>	<b>(756,553)</b>
Benefit for income taxes	233,088	279,410
<b>LOSS FROM CONTINUING OPERATIONS</b>	<b>(255,856)</b>	<b>(477,143)</b>
<b>DISCONTINUED OPERATIONS (Note 3)</b>		
Discontinued operations, net of income taxes		688,444
<b>NET INCOME (LOSS)</b>	<b>(255,856)</b>	<b>211,301</b>
Preferred stock dividends	150,000	151,000
<b>NET INCOME (LOSS) ATTRIBUTABLE TO COMMON STOCK</b>	<b>\$ (405,856)</b>	<b>\$ 60,301</b>
<b>NET INCOME (LOSS) PER SHARE:</b>		
<b>Basic</b>		
Continuing operations	\$ (0.03)	\$ (0.04)
Discontinued operations		0.05
<b>Total</b>	<b>\$ (0.03)</b>	<b>\$ 0.01</b>
<b>Diluted</b>		
Continuing operations	\$ (0.03)	\$ (0.04)
Discontinued operations		0.05
<b>Total</b>	<b>\$ (0.03)</b>	<b>\$ 0.01</b>

Edgar Filing: CONTANGO OIL & GAS CO - Form 10-Q

WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:

Basic	15,004,548	14,444,504
Diluted	15,004,548	14,444,504

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

**Table of Contents****CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Loss from continuing operations	\$ (255,856)	\$ (477,143)
Plus income from discontinued operations, net of income taxes		688,444
Net income (Loss)	(255,856)	211,301
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation, depletion and amortization	212,191	277,084
Exploration expenditures	531,907	256,119
Deferred income taxes	(262,120)	1,033,299
Tax benefit from cancellation of stock option	(29,032)	
Stock-based compensation	229,160	177,939
Changes in operating assets and liabilities:		
Decrease (increase) in accounts receivable and other	(289,673)	262,811
Increase in prepaid insurance	(188,250)	(188,188)
Increase in interest receivable	(20,599)	(23,013)
Increase in inventory	(139,972)	
Increase (decrease) in accounts payable and advances from joint owners	7,472,889	(196,115)
Increase (decrease) in other accrued liabilities	(398,409)	159,314
Increase (decrease) in income taxes payable	29,032	(1,658,548)
Gain on sale of assets and other	(84,391)	(17,748)
Net cash provided by operating activities	6,806,877	294,255
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Natural gas and oil exploration and development expenditures	(18,971,541)	(4,667,438)
Natural gas and oil exploration and development reimbursements, net of additions	(3,309,852)	278,186
Increase in net investment in affiliates	292,031	(83,176)
Investment in Freeport LNG Project		(75,000)
Sale of short-term investments, net	9,460,677	1,506,890
Additions to furniture and equipment		(1,938)
(Increase) decrease in advances to operators		112,725
Investment in Contango Venture Capital Corporation	(600,000)	(185,906)
Acquisition of Republic Exploration LLC and Contango Offshore Exploration interests		(7,500,000)
Net cash provided (used) by investing activities	(13,128,685)	(10,615,657)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from preferred equity issuances		10,000,000
Preferred stock dividends	(150,000)	(151,000)
Repurchase/cancellation of stock options	(181,540)	
Tax benefit from cancellation of stock option	29,032	
Proceeds from exercised options, warrants and others		389,036
Preferred equity issuance costs		(383,562)
Net cash provided (used) in financing activities	(302,508)	9,854,474



Edgar Filing: CONTANGO OIL & GAS CO - Form 10-Q

NET DECREASE IN CASH AND CASH EQUIVALENTS	(6,624,316)	(466,928)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	10,274,950	3,985,775
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 3,650,634	\$ 3,518,847
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for taxes	\$	\$ 710,000
Cash paid for interest	\$ 201,645	\$ 96

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

Table of Contents

**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY**

(Unaudited)

	For the Three Months Ended September 30, 2006							Total Shareholders Equity
	Preferred Stock		Common Stock		Paid-in Capital	Treasury Stock	Retained Earnings	
	Shares	Amount	Shares	Amount				
<b>Balance at June 30, 2006</b>	2,000	\$ 80	14,999,085	\$ 702,961	\$ 45,105,504	\$ (6,180,000)	\$ 22,911,047	\$ 62,539,592
Issuance of common stock			16,750	670	81,268			81,938
Expense of stock options					147,222			147,222
Repurchase/cancellation of stock options, net of tax benefit					(152,508)			(152,508)
Net loss							(255,856)	(255,856)
Preferred stock dividends							(150,000)	(150,000)
<b>Balance at September 30, 2006</b>	2,000	\$ 80	15,015,835	\$ 703,631	\$ 45,181,486	\$ (6,180,000)	\$ 22,505,191	\$ 62,210,388

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

**Table of Contents**

**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**1. Summary of Critical Accounting Policies**

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

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

When circumstances indicate that proved properties may be impaired, the Company compares expected undiscounted future cash flows on a cost center basis to the unamortized capitalized cost of the asset. If the future undiscounted cash flows, based on the Company's estimate of future natural gas and oil prices and operating costs and anticipated production from proved reserves, are lower than the unamortized capitalized cost, then the capitalized cost is reduced to fair market value.

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

**Table of Contents**

**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*Cash Equivalents.* Cash equivalents are considered to be highly liquid investment grade debt investments having an original maturity of 90 days or less. As of September 30, 2006, the Company had \$3,650,634 in cash and cash equivalents, of which \$2,097,485 was invested in highly liquid AAA-rated tax-exempt money market funds.

*Short Term Investments.* As of September 30, 2006, the Company had \$9,011,650 invested in a portfolio of periodic auction reset ( PAR ) securities, which have coupons that periodically reset to market interest rates at intervals ranging from 7 to 35 days. These PAR securities are being classified as short term investments and consist of AAA-rated tax-exempt municipal bonds. PAR securities are highly liquid and have minimal interest rate risk.

*Principles of Consolidation.* The Company's consolidated financial statements include the accounts of Contango Oil & Gas Company and its subsidiaries and affiliates, after elimination of all intercompany balances and transactions. Wholly-owned subsidiaries are fully consolidated. Exploration and development subsidiaries not wholly owned, such as 42.7% owned Republic Exploration LLC ( REX ), 50% owned Magnolia Offshore Exploration LLC ( MOE ), and 76.0% owned Contango Offshore Exploration LLC ( COE ) (see Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations, Offshore Gulf of Mexico Exploration Joint Ventures ) are not controlled by the Company and are proportionately consolidated. By agreement, REX, MOE and COE have disproportionate allocations of their profits and losses among the owners. Accordingly, the Company determines its income or losses from the ventures based on a hypothetical liquidation determination of how increases or decreases in the book value of the ventures' net assets will ultimately affect the cash payments to the Company in the event of dissolution.

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

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

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

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

**Table of Contents**

**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

In September 2006, the Securities and Exchange Commission staff issued Staff Accounting Bulletin ( SAB ) No. 108, incorporated into the SEC Rules and Regulations as Section N to Topic 1, Financial Statements, which provides guidance concerning the effects of prior year misstatements in quantifying current year misstatements for the purpose of materiality assessments. Specifically, entities must consider the effects of prior year unadjusted misstatements when determining whether a current year misstatement will be considered material to the financial statements at the current reporting period and record the adjustment, if deemed material. SAB No. 108 becomes effective for the first fiscal year ending after November 15, 2006, with adoption in the first interim period of that year encouraged. Upon adoption, entities may either restate the financial statements for each period presented or record the cumulative effect of the error correction as an adjustment to the opening balance of retained earnings at the beginning of the period of adoption, and provide disclosure of each individual error being corrected within the cumulative adjustment, stating when and how each error arose and the fact that the error was previously considered immaterial. We do not expect this authoritative guidance to have a material impact on our financial position, results of operations and cash flows.

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

*Stock-Based Compensation.* Effective July 1, 2001, the Company adopted the fair value based method prescribed in SFAS No. 123, *Accounting for Stock Based Compensation* . Under the fair value based method, compensation cost is measured at the grant date based on the fair value of the award and is recognized over the award vesting period. The fair value of each award is estimated as of the date of grant using the Black-Scholes options-pricing model. Effective July 1, 2005, the Company adopted SFAS No. 123 (revised 2004) ( SFAS 123(R) ), *Share-Based Payment* . Prior to the adoption of SFAS 123(R), the Company presented all benefits from the exercise of share-based compensation as operating cash flows in the statement of cash flows. SFAS 123(R) requires the benefits of tax deductions in excess of the compensation cost recognized for the options (excess tax benefit) to be classified as financing cash flows. The fair value of each option is estimated as of the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants during the quarters ended September 30, 2006 and 2005, respectively: (i) risk-free interest rate of 4.56 percent and 4.10 percent; (ii) expected lives of five years; (iii) expected volatility of 40 percent and (iv) expected dividend yield of zero percent.

Under the Company's 1999 Stock Incentive Plan, as amended (the 1999 Plan ), the Company's Board of Directors may also grant restricted stock awards to officers or other employees of the Company. Restricted stock awards made under the 1999 Plan are subject to such restrictions, terms and conditions, including forfeitures, if any, as may be determined by the Board. Restricted stock awards generally vest over a period of three years. Grants of service based restricted stock awards are valued at our common stock price at the date of grant. During the three months ended September 30, 2006, the Company granted 16,750 shares of restricted stock to its employees.

**Table of Contents**

**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

During the three months ended September 30, 2006 and 2005, the Company recorded stock-based compensation charges of \$229,160 and \$177,939 to general and administrative expense, respectively.

**2. Natural Gas and Oil Exploration Risk**

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

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

**3. Sale of Properties - Discontinued Operations**

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

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

In accordance with SFAS 144, we classified our properties held for sale as discontinued operations as of September 30, 2005.

**Table of Contents****CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The Company did not have any discontinued operations for the three months ended September 30, 2006. The summarized financial results for discontinued operations for the period ended September 30, 2005 are as follows:

	<b>Three months ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Operating Results:</b>		
Revenues	\$	\$ 1,042,771
Operating credits		214,499*
Depletion expense		(221,724)
Gain on sale of discontinued operations		23,598
Gain before income taxes	\$	\$ 1,059,144
Provision for income taxes	\$	\$ (370,700)
Gain from discontinued operations, net of income taxes	\$	\$ 688,444

\* Credits due to severance tax refunds

For the three months ended September 30, 2005, operating expenses from discontinued operations resulted in a net credit of \$214,499 which was attributable to a credit for previously paid severance taxes. The Railroad Commission of Texas allows for a severance tax reduction on tight sand gas wells. As a result, some of our properties sold in fiscal year 2005 were eligible for severance tax reduction. By contractual agreement, revenues and expenses prior to July 1, 2004, the effective date of the sale, accrue to us.

Table of Contents

## CONTANGO OIL &amp; GAS COMPANY AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**4. Net Income (Loss) Per Common Share**

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

	Three Months Ended		
	Loss	September 30, 2006 Weighted Average Shares	Per Share
Loss from continuing operations including preferred dividends	\$ (405,856)	15,004,548	\$ (0.03)
Discontinued operations, net of income taxes	\$	15,004,548	\$
<b>Basic Earnings per Share:</b>			
Net loss attributable to common stock	\$ (405,856)	15,004,548	\$ (0.03)
Effect of Potential Dilutive Securities:			
Stock options and warrants		(a)	
Series D preferred stock	(a)	(a)	
Loss from continuing operations including preferred dividends	\$ (405,856)	15,004,548	\$ (0.03)
Discontinued operations, net of income taxes	\$	15,004,548	\$
<b>Diluted Earnings per Share:</b>			
Net loss attributable to common stock	\$ (405,856)	15,004,548	\$ (0.03)
Anti-dilutive Securities:			
Shares assumed not issued from options to purchase common shares as income from continuing operations was in a loss position for the period	\$	925,875	\$ 7.93
Series D preferred stock	\$ 150,000	833,330	\$ 0.18

(a) Anti-dilutive.

	Three Months Ended		
	Income (Loss)	September 30, 2005 Weighted Average Shares	Per Share
Loss from continuing operations including preferred dividends	\$ (628,143)	14,444,504	\$ (0.04)
Discontinued operations, net of income taxes	688,444	14,444,504	0.05
<b>Basic Earnings per Share:</b>			
Net income attributable to common stock	\$ 60,301	14,444,504	\$ 0.01



Edgar Filing: CONTANGO OIL & GAS CO - Form 10-Q

Effect of Potential Dilutive Securities:

Stock options and warrants			(a)
Series D preferred stock	(a)		(a)
Loss from continuing operations including preferred dividends	\$ (628,143)	14,444,504	\$ (0.04)
Discontinued operations, net of income taxes	688,444	14,444,504	0.05

**Diluted Earnings per Share:**

Net income attributable to common stock	\$ 60,301	14,444,504	\$ 0.01
---	-----------	------------	---------

Anti-dilutive Securities:

Shares assumed not issued from options to purchase common shares as income from continuing operations was in a loss position for the period	\$	1,184,000	\$ 6.78
Series C preferred stock (converted during the period)	\$ 21,000	1,166,667	\$ 0.02
Series D preferred stock	\$ 130,000	833,330	\$ 0.16

(a) Anti-dilutive.

---

**Table of Contents**

**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**5. Acquisition of Interest in Partially-Owned Subsidiaries and Overriding Royalties**

On September 2, 2005, we purchased an additional 9.4% ownership interest in each of our two partially-owned offshore Gulf of Mexico exploration subsidiaries, REX for \$5.6 million and COE for \$1.9 million, for a total expenditure of \$7.5 million. Both interests were purchased from Juneau Exploration, L.P. ( JEX ), which prior to the sale, owned 33.3% of each of the two subsidiaries. As a result of these two purchases, the Company's equity ownership interest in REX has increased from 33.3% to 42.7% and in COE from 66.6% to 76.0%. The purchases were financed from the Company's existing cash on hand. An independent third party also purchased a 9.4% interest in each of REX and COE from JEX for the same total purchase price of \$7.5 million. JEX will continue in its capacity as the managing member of both REX and COE and following these two sales, now owns a 14.6% interest in each of REX and COE.

During the quarter ended September 30, 2005, the purchase price paid in excess of the subsidiaries net assets acquired ( purchase price allocation ) was allocated to the various assets owned by the subsidiaries. These assets include planned drilling commitments, unevaluated exploration blocks, and proven developed producing properties. A significant portion of the purchase price allocation was allocated to our Eugene Island 10 ( Dutch ) and Grand Isle 63/72/73 ( Liberty ) exploration prospects.

On November 7, 2005, the Company, in a separate transaction, also acquired certain overriding royalty interests in REX, COE and MOE offshore prospects for the purchase price of \$1.0 million.

**6. Series D Perpetual Cumulative Convertible Preferred Stock**

On July 15, 2005, we sold \$10.0 million of our Series D preferred stock to a group of private investors. The Series D preferred stock is perpetual and cumulative, is senior to our common stock and is convertible at any time into shares of our common stock at a price of \$12.00 per share. The dividend on the Series D preferred stock can be paid quarterly in cash at a rate of 6.0% per annum or paid-in-kind at a rate of 7.5% per annum. Our registration statement filed with the Securities and Exchange Commission, covering the 833,330 shares of common stock issuable upon conversion of the Series D preferred stock, became effective on October 26, 2005. Net proceeds associated with the private placement of the Series D preferred stock was \$9,616,438, net of stock issuance costs.

**7. Conversion of Series C Cumulative Convertible Preferred Stock into Common Stock**

On July 19, 2005, we exercised our mandatory conversion rights pursuant to the terms of our Series C preferred stock, and converted all of the remaining 1,400 shares of our Series C preferred stock issued and outstanding into 1,166,662 shares of common stock. The outstanding shares of the Series C preferred stock had a face value of \$7.0 million, and paid a 6.0% per annum quarterly cash dividend.

**8. Investment in Freeport LNG**

As of September 30, 2006, the Company has invested \$3.2 million and owns a 10% limited partnership interest in Freeport LNG Development, L.P. ( Freeport LNG ), a limited partnership formed to develop, construct and operate a 1.5 billion cubic feet per day ( Bcf/d ) liquefied natural gas ( LNG ) receiving terminal in Freeport, Texas.

---

**Table of Contents**

**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**9. Contango Venture Capital Corporation**

As of September 30, 2006, Contango Venture Capital Corporation ( CVCC ), our wholly-owned subsidiary, held a direct investment in three alternative energy portfolio companies - Trulite, Inc. ( Trulite ), Gridpoint, Inc. ( Gridpoint ) and Moblize Inc. ( Moblize ). Our investment in each of Trulite and Gridpoint is less than 20% and we account for these investments under the cost method. Our investment in Moblize rose above 20% during the three months ended September 30, 2006 when the Company exercised its right pursuant to two warrants, to purchase additional shares of the company. We now account for this investment under the equity method.

*Trulite, Inc.* As of September 30, 2006, CVCC had invested \$0.9 million in Trulite in exchange for 2,001,014 shares of Trulite common stock, which represents an approximate 17% ownership interest. Trulite develops lightweight hydrogen generators for fuel cell systems.

*Gridpoint, Inc.* As of September 30, 2006, CVCC had invested \$1.0 million in Gridpoint in exchange for 333,333 shares of Gridpoint preferred stock, which represents an approximate 1.8% ownership interest. Gridpoint's intelligent energy management products ensure clean, reliable power, increase energy efficiency, and integrate renewable energy. With Gridpoint, home and business owners can automatically protect themselves from power outages, manage their energy online and reduce their carbon footprint. Gridpoint's plug-and-play appliances are easy to install and are sold through a network of premium home builders, utilities, retail chains and government entities as well as installers and contractors of electrical, heating, air-conditioning, home automation, power quality and renewable energy systems.

*Moblize Inc.* As of September 30, 2006, CVCC had invested \$1.2 million in Moblize in exchange for 648,648 shares of Moblize convertible preferred stock, which represents an approximate 33% ownership interest. Moblize develops real time diagnostics and field optimization solutions for the oil and gas industry using open-standards based technologies. Moblize is deploying its technology in oil fields near Houston belonging to Chevron U.S.A. Inc. and on our Grand Isle 72 development, which will allow COI to remotely monitor, control and record, in real time, daily production volumes.

In June 2004, CVCC acquired a 32% membership interest in Contango Capital Partnership Management, LLC ( CCPM ) for \$0.5 million. CVCC is the 25% limited partner of, and CCPM is the general partner of, Contango Capital Partners, L.P., which was formed in January 2005 for the purpose of investing in the energy venture capital market. Contango Capital Partners, L.P. then formed Contango Capital Partners Fund, L.P. (the Fund ).

On January 31, 2005, the Fund was closed to new investments with a total capitalization of \$8.2 million in the form of contributed stock, cash, and future cash commitments. Prior to CVCC holding a direct interest in Trulite and Moblize, the Fund previously held these investments. The Fund also had an investment in Synexus Energy, Inc. ( Synexus ). Synexus is a portable and stationary fuel cell integrator developing technology with a lightweight fuel cell stack that will create both portable and stationary power solutions for customers. In April 2006, Trulite acquired Synexus technology. In May 2006, the Fund distributed its pro rata shares of Trulite to CVCC. In June 2006, the Fund sold its investment in Moblize to CVCC for \$0.6 million.

As of September 30, 2006, CVCC owns 25% of the Fund. The Fund currently holds a direct investment in two alternative energy companies Protonex Technology Corporation ( Protonex ) and Jadoo Power Systems ( Jadoo ). We account for these investments under the equity method.

*Protonex Technology Corporation.* As of September 30, 2006, the Fund has invested \$1.5 million in Protonex in exchange for 2,400,000 shares of Protonex stock, which represents an approximate 7% ownership interest. Protonex provides long-duration portable and remote power sources with a focus on providing solutions to the U.S. military and supplies complete power solutions and application engineering services to original equipment

**Table of Contents**

**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

manufacturers customers. During the period, Protonex began trading its common shares on the AIM market of the London Stock Exchange under the stock symbol PTX.L. As a result, the Fund marks-to-market its investment in Protonex based on public pricing. At September 30, 2006, the Fund's investment in Protonex had a mark-to-market value of approximately \$4.3 million.

*Jadoo Power Systems.* As of September 30, 2006, the Fund has invested approximately \$1.2 million and owns 2,200,000 shares of Jadoo stock, which represents an approximate 5% ownership interest. Jadoo develops high energy density power products for the law enforcement, military and electronic news gathering applications. As of September 30, 2006, the Fund's investment in Jadoo had a valuation of approximately \$1.2 million.

Since the Fund's inception, the Company has recorded a cumulative \$0.8 million increase to our investment resulting primarily from unrealized gains of the Fund as a result of mark-to-market adjustments that have been made due to the increase in the value of our alternative energy investments, bringing our total investment in alternative energy investments, including cumulative mark-to-market adjustments, as of September 30, 2006, to approximately \$5.1 million.

**10. Long-Term Debt**

The Company has \$10.0 million outstanding under a three-year \$20.0 million secured term loan agreement with The Royal Bank of Scotland (RBS). The term loan agreement is secured with the stock of Contango Sundance, Inc. (Sundance), our wholly-owned subsidiary. Sundance owns a 10% limited partnership interest in Freeport LNG, which owns the Freeport LNG facility. Borrowings under the term loan agreement bear interest, at the Company's option, at either (i) 30 day LIBOR, (ii) 60 day LIBOR, (iii) 90 day LIBOR or (iv) 6 month LIBOR, all plus 6.5%. Interest is due at the end of the LIBOR period chosen. The principal is due April 27, 2009, but we may prepay after April 27, 2008 with no prepayment penalty.

The term loan agreement requires a minimum level of working capital, as defined in the term loan agreement. Additionally, the term loan agreement contains certain negative covenants that, among other things, restrict or limit our ability to incur indebtedness, sell certain assets, and pay dividends. Failure to maintain required working capital or comply with the term loan agreement's covenants could result in a default and acceleration of all indebtedness under the term loan agreement. As of September 30, 2006, the Company was in compliance with its financial covenants, ratios and other provisions of the term loan agreement.

The Company also has an unsecured credit facility with Guaranty Bank, FSB. Although the Company has no debt outstanding under this credit facility as of September 30, 2006, the facility is being maintained and provides for a borrowing capacity of \$0.1 million and matures on June 29, 2008. Borrowings will bear interest, at the Company's option, at either (i) LIBOR plus two percent (2%) or (ii) the bank's base rate plus one-fourth percent (1/4%) per annum. Additionally, the Company pays a quarterly commitment fee of three-eighths percent (3/8%) per annum on the average availability.

The hydrocarbon borrowing base is subject to semi-annual redetermination based primarily on the value of our proved reserves. The credit facility requires the maintenance of certain ratios, including those related to working capital, funded debt to EBITDAX (earnings before interest, income taxes, depreciation, depletion and amortization, impairment expenses, exploration expenses, including gain (loss) from hedging activities (if any), and sale of assets and other), and debt service coverage, as defined in the credit agreement. Additionally, the credit agreement contains certain negative covenants that, among other things, restrict or limit our ability to incur indebtedness, sell assets, pay dividends and reacquire or otherwise acquire or redeem capital stock. Failure to maintain required financial ratios or comply with the credit facility's covenants can result in a default and acceleration of all indebtedness under the credit facility.

**Table of Contents**

**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

As of September 30, 2006, the Company was in compliance with its financial covenants, ratios and other provisions of its credit facility.

**11. Related Party Transactions**

In August 2006, the Company loaned \$125,000 to Trulite under a Promissory Note (the Trulite Note ). The Note bears interest at a per annum rate of 11.25% until February 9, 2007, at which point the per annum rate will change to prime rate plus three percentage points until May 1, 2007, which is when the Trulite Note plus all accrued and unpaid interest is due.

In July 2006, the Company purchased options from one of the members of the Board of Directors for \$91,190. No equity securities of the Company were repurchased during the three months ended September 30, 2006. We do not have a publicly announced program to repurchase shares of our common stock.

On March 31, 2006, COE executed a Promissory Note (the COE Note ) to the Company, in the aggregate principal amount of up to \$2,800,550. Under the terms of the COE Note, COE can borrow up to the stated amount to receive funding in connection with a certain Authority for Expenditure ( AFE ) dated March 20, 2006 related to the Grand Isle 72 well, in which COE is a working interest owner. The COE Note is payable upon demand and bears interest at a per annum rate of 10%. As of September 30, 2006, the outstanding principal balance under the COE Note was \$1,000,000 and the amount of accrued interest thereon was approximately \$26,000.

**12. Subsequent Events**

*Term Loan Facility.* On October 26, 2006, the Company borrowed the remaining \$10.0 million available under its three-year \$20.0 million secured term loan agreement with RBS. The Company's total long-term debt outstanding is now \$20.0 million.

On October 26, 2006, REX executed a Demand Promissory Note (the REX Note ) with one of our offshore partners which is non-recourse to Contango. Under the terms of the REX Note, REX can borrow up to \$50.0 million at a per annum rate of 11.5% for the first advance, and a per annum rate of LIBOR plus six percent for each additional advance. All advances are payable in full on the earlier of October 26, 2008 or upon demand. The first advance in the amount of \$5.0 million was made on October 27, 2006. The REX Note is secured by substantially all the assets of REX including the leasehold interests and production attributable to REX from the Eugene Island 10 exploration discovery in the Gulf of Mexico. Contango's share of such obligation and interest expense will be reflected in future financial statements as a result of our proportionate consolidation of REX.

## **Table of Contents**

### **Available Information**

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

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the financial statements and the accompanying notes and other information included elsewhere in this Form 10-Q and in our Form 10-K for the fiscal year ended June 30, 2006, previously filed with the Securities and Exchange Commission.

### **Cautionary Statement about Forward-Looking Statements**

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

Our financial position

Business strategy and budgets

Anticipated capital expenditures

Drilling of wells

Natural gas and oil reserves

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

Operating costs and other expenses

Cash flow and anticipated liquidity

Prospect development

Property acquisitions and sales

Development, construction and financing of our liquefied natural gas ( LNG ) receiving terminal

Investment in alternative energy

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

Low and/or declining prices for natural gas and oil

Natural gas and oil price volatility

Interest rate volatility

The risks associated with acting as the operator in drilling deep high pressure wells in the Gulf of Mexico

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

Availability of capital and the ability to repay indebtedness when due

Availability of rigs and other operating equipment

Ability to raise capital to fund capital expenditures

**Table of Contents**

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

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

Operating hazards attendant to the natural gas and oil business

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

Potential mechanical failure or under-performance of significant wells or pipeline mishaps

Weather

Availability and cost of material and equipment

Delays in anticipated start-up dates

Actions or inactions of third-party operators of our properties

Ability to find and retain skilled personnel

Strength and financial resources of competitors

Federal and state regulatory developments and approvals

Environmental risks

Worldwide economic conditions

Ability of LNG to become a competitive energy supply in the United States

Ability to fund our LNG project, cost overruns and third party performance

Successful commercialization of alternative energy technologies



## Edgar Filing: CONTANGO OIL & GAS CO - Form 10-Q

Drilling costs, production rates and ultimate reserve recoveries in our Arkansas Fayetteville Shale play.

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

### **Overview**

Contango is a Houston-based, independent natural gas and oil company. The Company's core business is to explore, develop, produce and acquire natural gas and oil properties primarily offshore in the Gulf of Mexico and in the Arkansas Fayetteville Shale. Contango Operators, Inc. (COI), our wholly-owned subsidiary, acts as operator on certain offshore prospects. The Company also owns a 10% interest in a limited partnership formed to develop an LNG receiving terminal in Freeport, Texas, and holds investments in companies focused on commercializing environmentally preferred energy technologies.

### **Our Strategy**

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

*Funding exploration prospects generated by our alliance partners.* We depend on our alliance partners for prospect generation expertise. Our alliance partners, Juneau Exploration, L.P. (JEX) and Alta Resources, LLC (Alta) are experienced and have successful track records in exploration.

*Using our capital availability to increase our reward/risk potential on selective prospects.* We have concentrated our risk investment capital in two prospect areas; our onshore Arkansas Fayetteville Shale play and our offshore Gulf of Mexico prospects. Exploration prospects are inherently risky as they require

## **Table of Contents**

large amounts of capital with no guarantee of success. COI, our wholly-owned subsidiary, will drill and operate our offshore prospects. Should we be successful in any of our offshore prospects, we will have the opportunity to spend significantly more capital to complete development and bring the discovery to producing status.

*Operating in the Gulf of Mexico.* COI was formed for the purpose of drilling and operating exploration wells in the Gulf of Mexico. COI has drilled five exploration wells in the Gulf of Mexico, of which three have been successful. This represents a significant increase in the risk profile of the Company since the Company has limited operating experience. Our estimated drilling costs could be significantly higher if we encounter difficulty in drilling offshore wells.

*Arkansas Fayetteville Shale.* We have made a major commitment to our Arkansas Fayetteville Shale program and this commitment is expected to continue to grow as we participate in the drilling of hundreds of gross exploration/development wells over the next five to ten years.

*Sale of proved properties.* From time-to-time as part of our business strategy, we have sold and in the future may continue to sell some or a substantial portion of our proved reserves to capture current value, using the sales proceeds to further our exploration, LNG and alternative energy investment activities. Since its inception, the Company has sold over \$80.0 million worth of oil and natural gas properties, and views periodic reserve sales as an opportunity to capture value, reduce reserve and price risk, and as a source of funds for potentially higher rate of return natural gas and oil exploration opportunities.

On March 24, 2006, the Company's Board of Directors approved the sale of all of the Company's onshore producing assets in Texas and Alabama for an aggregate purchase price of \$11.6 million. These properties were held by Contango STEP, LP (STEP), an indirect wholly-owned subsidiary of the Company. The sale was completed in June 2006. The sold properties had net reserves of approximately 203 thousand barrels (Mbbbl) of oil and 849 million cubic feet (MMcf) of gas, or 2.1 billion cubic feet equivalent (Bcfe). The Company recognized a pre-tax gain of \$6.2 million for the year ended June 30, 2006.

In March 2006, we sold a producing well in south Texas for approximately \$2.0 million to an independent oil and gas company. Approximately 227 MMcf of proven reserves were sold. Pre-tax proceeds after netting adjustments were \$2.0 million.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 144 (SFAS 144), Accounting for the Impairment or Disposal of Long-Lived Assets, we classified all our property sales as discontinued operations.

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

*Structuring transactions to share risk.* Our alliance partners share in the upfront costs and the risk of our exploration prospects.

*Structuring incentives to drive behavior.* We believe that equity ownership aligns the interests of our partners, employees, and stockholders. Our directors and executive officers beneficially own or have voting control over approximately 21% of our common stock.

**Table of Contents****Exploration Alliances with JEX and Alta**

*Alliance with JEX.* JEX is a private company formed for the purpose of assembling domestic natural gas and oil prospects. Under our agreement with JEX, JEX generates natural gas and oil prospects and evaluates exploration prospects generated by others. JEX focuses on the Gulf of Mexico, and generates offshore exploration prospects via our affiliated companies, REX, COE and MOE (see Offshore Gulf of Mexico Exploration Joint Ventures below).

*Alliance with Alta.* Alta Resources, LLC (Alta) is a private company formed for the purpose of assembling domestic, onshore natural gas and oil prospects. Our arrangement with Alta generally provides for us to pay our share of seismic and lease costs, with Alta generally receiving a negotiated overriding royalty interest and a carried or back-in working interest.

**Onshore Exploration and Properties***Alta Activities***Arkansas Fayetteville Shale**

In March 2005, Contango and Alta entered into an agreement to acquire natural gas, oil, and mineral leases in the Arkansas Fayetteville Shale play area located in Pope, Van Buren, Conway, Faulkner, Cleburne, and White Counties, Arkansas. As of November 3, 2006, we and our partners have acquired or received commitments on approximately 44,300 net mineral acres at a cost of approximately \$11.7 million. Our 70% share of the acquisition costs is approximately \$8.2 million.

Of these 44,300 acres, approximately 16,700 acres, or 38%, are located in an area containing proved producing wells in the Fayetteville Shale. Additionally, 5,600 acres (13%) are located in our Pigeon Roost exploration area; 5,100 acres (11%) are located in our Buck Ridge exploration area (both Pigeon Roost and Buck Ridge are within Alta's geologically defined target area for the shale); 11,700 acres (26%) are located within Alta's target area, but outside of proved production and our current exploration areas, and 5,200 acres (12%) are located south of Alta's target area, and are considered highly speculative.

The Arkansas Oil & Gas Commission has now approved nineteen 640-acre drilling units in Conway County, Arkansas that we estimate will allow our partnership to drill and operate approximately 171 horizontal wells. The horizontal wells are estimated to cost between \$3.0 to \$2.2 million each. We estimate our working interest and net revenue interest in these Alta operated wells will average between 50% to 40% and 45% to 32%, respectively. Alta intends to continue to seek approval from the Arkansas Oil & Gas Commission for additional 640-acre units.

We currently estimate that Alta will be operating 17 wells by June 30, 2007. Of these 17 wells, two, the Alta-Beck and the Alta-Briggler, were spud in fiscal year 2006; three, the Alta-Thines, the Alta-Ledbetter and the Alta-Clark, were spud during the quarter ended September 2006 and two, the Alta-Wooten and the Alta-Kaufman, were spud in October 2006. The following table provides a description of our Alta wells and our working interest and net revenue interest in each:

<b>Well Name</b>	<b>WI</b>	<b>NRI</b>	<b>Expected First Production</b>
Alta-Beck 1-32H	38.65%	30.92%	February 2007
Alta-Briggler 1-31H	69.74%	54.90%	March 2007
Alta-Thines 1-30H	34.87%	27.42%	March 2007
Alta-Ledbetter 1-33H	60.42%	48.34%	March 2007
Alta-Clark 1-26H	57.24%	45.80%	April 2007
Alta-Wooten 1-34H	53.19%	42.56%	April 2007
Alta-Kaufman 1-12H	58.96%	46.53%	May 2007

**Table of Contents**

The 8/8ths cost for drilling and completing these seven wells is \$21.5 million (\$11.6 million net to Contango). Of this \$11.6 million, we have already invested \$6.9 million as of November 3, 2006, and estimate we will invest \$4.7 million in November 2006 for the remaining drilling, frac, completion and hook-up costs of these wells. For the remaining ten wells to be drilled during the remainder of fiscal year 2007, the net cost to us is estimated to be \$14.4 million.

In addition, we have been integrated into 68 wells located in our Arkansas Fayetteville Shale play as of November 3, 2006, that are being operated by a third party independent oil and gas exploration company ( Integrated Wells ). Of these wells, three are vertical wells and 19 are horizontal wells. Of these 22 producing wells, the 8/8ths production is approximately 19.3 million cubic feet per day ( MMcf/d ) as of October 31, 2006. The remaining 46 horizontal wells are either currently being drilled or are expected to be drilled over the next several months with our net share of the total drilling costs estimated at \$6.4 million. Our average working and net revenue interest in these 68 Integrated Wells thus far is approximately 6% and 5%, respectively.

**Texas, Alabama, and Louisiana**

During the three months ended September 30, 2006, we spud two of three additional onshore wells we plan on drilling with our alliance partner Alta, the Alta-Ellis #1 in Texas, in which we have a 50% working interest and the Temple Inland #1 in Louisiana, in which we have a 77% working interest. Both proved to be discoveries. For the Alta-Ellis #1, we estimate net reserves of approximately 30 Mbbls of oil, and expect to begin production in the first quarter of calendar year 2007. For the Temple Inland #1, we estimate net reserves of approximately 385 MMcfe and expect to begin production in the first quarter of calendar year 2007. We expect to spud the third well, the Alta-Coley #1 in Alabama, in which we have a 67.5% working interest, by the end of this calendar year, at an 8/8ths dry hole cost of approximately \$1.0 million.

We have also expanded our shale play activity in the developing West Texas Barnett Shale Play in Jeff Davis and Reeves Counties, Texas, with Alta. The Alta group has leased approximately 5,800 net mineral acres (4,000 net mineral acres to Contango before a basket payout). A third party operator has drilled a few wells near our acreage. Our plans are to monitor activity in this play before commencing operations.

**Offshore Gulf of Mexico Exploration Joint Ventures**

Contango directly and through affiliated companies conducts exploration activities in the Gulf of Mexico. As of November 3, 2006, Contango and its affiliates have interests in 66 offshore leases. On August 16, 2006, REX was the apparent high bidder on three lease blocks at the Western Gulf of Mexico Lease Sale # 200. In September 2006, we were notified that two of the lease blocks, High Island A196 and High Island A197, had been awarded. The third lease block, High Island A198, was awarded in October 2006. The sale covered areas in the western part of the Outer Continental Shelf, offshore from the Texas coastline. See Offshore Properties below for additional information on our offshore properties.

As of September 30, 2006, Contango owned a 42.7% equity interest in REX, a 76.0% equity interest in COE, and a 50.0% equity interest in MOE, all of which were formed for the purpose of generating exploration opportunities in the Gulf of Mexico. These companies have collectively licensed approximately 3,900 blocks of 3-D seismic data and have focused on identifying prospects, acquiring leases at federal and state lease sales and then selling the prospects to third parties, including Contango, subject to timed drilling obligations plus retained reversionary interests in favor of REX, COE and MOE.

*Republic Exploration LLC.* On September 2, 2005, Contango purchased an additional 9.4% ownership interest in REX for \$5.625 million from JEX. As a result of this purchase, our equity ownership interest in REX increased from 33.3% to 42.7% and as of September 30, 2006, Contango had approximately \$5.8 million invested in REX. The three other members of REX are JEX, its managing member, a privately held investment company, and a privately held seismic company. REX holds a non-exclusive license to approximately 2,083 blocks of 3-D seismic

**Table of Contents**

data in the shallow waters of the Gulf of Mexico. This data is used to identify, acquire and exploit natural gas and oil prospects. All leases owned by REX are subject to a 3.3% overriding royalty interest in favor of the JEX prospect generation team. See *Offshore Properties* below for more information on REX's offshore properties.

*Contango Offshore Exploration LLC.* On September 2, 2005, Contango purchased an additional 9.4% ownership interest in COE for \$1.875 million from JEX. As a result of this purchase, our equity ownership interest in COE increased from 66.6% to 76.0%. As of September 30, 2006, Contango had approximately \$18.7 million invested in COE, which COE has used to acquire and reprocess 1,815 blocks of 3-D seismic data and to acquire leases in the Gulf of Mexico. The two other members of COE are JEX, its managing member, and a privately held investment company. All leases are subject to a 3.3% ORRI in favor of the JEX prospect generation team. See *Offshore Properties* below for additional information on COE's offshore properties.

Grand Isle 72 ( *Liberty* ), a COE prospect, was successfully tested in March 2006. As of October 31, 2006, the Company has invested approximately \$7.0 million to drill and complete the well, and approximately \$3.0 million in pipeline and production facilities. We estimate an additional \$2.2 million will be required to complete production and pipeline facilities and commence production. We believe, subject to Gulf of Mexico weather conditions, that this well will be on-stream by December 2006, with an estimated initial 8/8ths equivalent production rate of 7-10 million cubic feet equivalent per day ( *MMcfe/d* ). The net revenue interests to COI and COE after well completion is estimated to be 20% and 40%, respectively.

As of September 30, 2006, COE has borrowed \$1.0 million from the Company under a promissory note (the *Note* ) to fund a portion of its share of development costs at Grand Isle 72. The Note bears interest at a per annum rate of 10% and is payable upon demand. We anticipate that COE will need to borrow an additional \$1.5 million from the Company to complete pipeline hook-up and begin production.

Grand Isle 70, a COE prospect, was spud in July 2006 and proved to be a discovery. The well has been temporarily abandoned while various development scenarios are being evaluated.

*Magnolia Offshore Exploration LLC.* As of September 30, 2006, Contango had approximately \$1.0 million invested in MOE. JEX is the only other member of MOE and acts as the managing member, deciding which prospects MOE may acquire, develop, and exploit. MOE's license rights to 3-D seismic data have been assigned to COE. All leases are subject to a 3.3% ORRI in favor of the JEX prospect generation team. See *Offshore Properties* below for additional information on MOE's offshore properties.

*Current Activities.* In October 2006, REX was awarded the following three lease blocks from the Western Gulf of Mexico Lease Sale #200 for an aggregate purchase price of approximately \$1.0 million: High Island A196, High Island A197 and High Island A198. The blocks are complimentary to our existing High Island prospects.

In June 2006, REX was awarded Vermillion Block 194 for a purchase price of \$157,000. In May 2006, REX was awarded West Delta 77 for a purchase price of \$1.6 million, and COE was awarded the Viosca Knoll 119 and Viosca Knoll 383 lease blocks for an aggregate purchase price of approximately \$0.4 million.

In April 2006, at the Central Gulf of Mexico Lease Sale #198, COE was awarded Grand Isle Block 70 and Ship Shoal Block 26 for an aggregate purchase price of approximately \$1.4 million.

In March 2006, REX was awarded the following six lease blocks from the Central Gulf of Mexico Lease Sale # 198 for an aggregate purchase price of approximately \$0.9 million: South Marsh Island 57, South Marsh Island 59, South Marsh Island 75, South Marsh Island 282, Ship Shoal 14 and Ship Shoal 25. The blocks are complimentary to our existing Ship Shoal and South Marsh Island prospects.

**Table of Contents**

REX and COE have farmed out the following lease blocks: Main Pass 221, East Breaks 369/370, and Vermillion 154. Main Pass 221 was drilled and was determined to be a dry hole. East Breaks 369 and East Breaks 370 are expected to spud in 2007. COE will receive a 4.3% overriding royalty interest before project payout and a 7.2% overriding royalty interest after project payout on the East Breaks 369/370 prospects. Vermillion 154 has been farmed out, and the operator expects to drill an exploratory well prior to July 2008. During fiscal year 2006, the agreement to farm out and drill an exploratory well on West Cameron 133 was cancelled and two lease blocks, Viosca Knoll 116 and 119, were relinquished to the MMS. Also during fiscal year 2006, West Delta 36 was farmed out and began drilling. The well proved to be a discovery and was completed in September 2006. The operator expects to commence production by the end of December 2006. REX has a 3.67% ORRI before payout and, at its option, may elect either a 5.0% ORRI or 25% WI after payout.

Record title interests in the Vermilion 73 and South Marsh Island 247 leases have been assigned to a common third party. A timetable for drilling the two prospects has not yet been established. Under the farm-out agreement, REX reserves a 5.0% overriding royalty interest before payout in both prospects. In the Vermilion 73 prospect, REX also has the option after payout to maintain its 5.0% overriding royalty interest or receive a 25.0% working interest in the prospect.

The MMS has implemented a rule on royalty relief for shallow water, deep shelf natural gas production from certain Gulf of Mexico leases.

Deep shelf gas refers to natural gas produced from depths greater than 15,000 feet in waters of 200 meters or less. Royalty relief is available on the first 15 billion cubic feet ( Bcf ) of natural gas production if produced from an interval between 15,000 to less than 18,000 feet. Royalty relief is available on the first 25 Bcf of natural gas production if produced from an interval between 18,000 to less than 20,000 feet. Royalty relief is available on the first 35 Bcf of natural gas production if produced from well depths at or greater than 20,000 feet. This royalty relief is expected to have a positive impact on the economics of deep gas wells drilled on the shelf of the Gulf of Mexico.

*Effect of Gulf Coast Hurricanes.* In August 2005, Hurricane Katrina struck the Gulf of Mexico and the Gulf Coast of the United States, and in September 2005, Hurricane Rita struck the same region. At the time, the Company did not own or operate any production platforms or pipeline facilities in the Gulf of Mexico. The Company did, however, have non-operating working interests in three offshore blocks: Ship Shoal 358, Eugene Island 113-B and Eugene Island 76. Contango's net revenue interest in these three wells is 5.8%, 3.1% and 2.14%, respectively. The Company depends on third-party operators for the operation and maintenance of these production platforms. In the aftermath of the hurricanes, the Ship Shoal 358 and the Eugene Island 113-B platforms sustained damage and have now been repaired. Eugene Island-113B resumed production in April 2006, and on October 17, 2006, was producing at a rate of 7.2 MMcfe/d. The well has since been shut-in for unrelated repairs and production is estimated to commence later in November 2006. The Ship Shoal 358 well resumed production in April 2006, and on October 31, 2006, was producing at a rate of 2.9 MMcfe/d. The Company was not responsible for any of the capital costs required to repair the damaged platforms, pipelines, or other damaged facilities related to these wells and was not materially impacted by the temporary loss of production from these two wells. Eugene Island 76, a REX prospect, was successfully tested in 2005 and began producing in January 2006. The well is currently producing at approximately 4.3 MMcfe/d. REX owns an overriding royalty interest of 5% until payout, after which REX has the option to elect an 8.33% overriding royalty interest or a 25% working interest upon payout.

**Contango Operators, Inc.**

COI is a wholly-owned subsidiary of Contango formed for the purpose of drilling exploration and development wells in the Gulf of Mexico. As part of our strategy, COI will operate and acquire significant working interests in offshore exploration and development opportunities in the Gulf of Mexico, usually under a farm-out agreement with either REX or COE. COI expects to take working interests in these prospects under the same arms-length terms offered to third party industry participants. COI may also operate and acquire significant working interests in offshore exploration and development opportunities under farm-in agreements with third parties.

**Table of Contents**

*Current Activities.* In July 2006, we spud our Eugene Island 10 ( Dutch ) prospect, located offshore Louisiana in the Gulf of Mexico. In October 2006, we announced an exploration discovery at Dutch. A production liner has been set and electric logs run. Contango's independent third party engineer estimates this well to have proved reserves net to Contango of 25 billion cubic feet equivalent ( Bcfe ). As of October 31, 2006, the Company has invested approximately \$4.0 million to drill and complete this well. We estimate an additional \$2.2 million will be required to build production and pipeline facilities to commence production. COI has an 18.3% working interest and REX has a 65% working interest in Dutch. The net revenue interests to COI and REX are estimated to be approximately 13% and 47%, respectively. The net revenue interest before payout to Contango, as a whole, is approximately 33%. We believe the well will be on-stream by January 2007, with an estimated initial 8/8ths equivalent production rate of 30 MMcfe/d. Additionally, we are building a pad for our second exploratory well at Dutch.

**Offshore Properties**

*Producing Properties.* The following table sets forth the interests owned by Contango and related entities in the Gulf of Mexico which are producing natural gas or oil as of November 3, 2006:

<b>Area/Block</b>	<b>WI</b>	<b>NRI</b>	<b>Status</b>
<i>Contango Operators, Inc:</i> Eugene Island 113B	0%	1.7%	Producing
<i>Republic Exploration LLC:</i> Eugene Island 113B Eugene Island 76	0% (1)	3.3% 5.0%	Producing Producing
<i>Contango Offshore Exploration LLC:</i> Ship Shoal 358, A-3 well	10.0%	7.7%	Producing

(1) REX has a 5% of 8/8 overriding royalty interest ( ORRI ) in the lease before payout. At payout, REX may elect to either (i) escalate its ORRI in the lease from 5% to 8-1/3% of 8/8 or (ii) convert the 5% ORRI to a 25% working interest ( WI ).

**Table of Contents**

*Farmed-Out Properties.* The following table sets forth the working interests and net revenue interests owned by Contango and related entities in the Gulf of Mexico which have been farmed out as of November 3, 2006:

<b>Area/Block</b>	<b>WI</b>	<b>NRI</b>	<b>Status</b>
<i>Republic Exploration LLC:</i>			
Vermilion 154	(2)	(2)	Drilling expected by summer 2008
Vermillion 73	(3)	(3)	Determined to be a dry hole
South Marsh Island 247	(4)	(4)	No drilling date has been determined yet
West Delta 36	(5)	(5)	Completed. Production estimated to begin by Dec 2006
<i>Contango Offshore Exploration LLC:</i>			
Main Pass 221	(6)	(6)	Determined to be a dry hole
East Breaks 369	(7)	(7)	Drilling expected by Sept 2007
East Breaks 370	(7)	(7)	Drilling expected by Sept 2008
Vermilion 154	(2)	(2)	Drilling expected by summer 2008

- (2) REX and COE will split a 25% back-in WI after payout.
- (3) Record title interest in lease has been assigned to a third party. REX has a 5% of 8/8ths ORRI in the lease before payout. At payout, REX may elect to either (i) maintain its 5% ORRI in the lease or (ii) convert the 5% ORRI to a 25% WI.
- (4) Record title interest in lease has been assigned to a third party. REX has reserved a 5% of 8/8ths ORRI before payout.
- (5) REX will retain a 3.67% ORRI before payout. Upon payout REX will either increase to 5% ORRI or convert to a 25% WI after payout.
- (6) COE has a 5% of 8/8ths ORRI before payout. Upon payout, COE's ORRI will escalate to 7.2% of 8/8ths.
- (7) COE will receive a 4.27% ORRI before project payout and a 7.27% ORRI after project payout.

*Farmed-In Properties.* The following table sets forth the working interests and net revenue interests owned by Contango and related entities in the Gulf of Mexico which have been farmed in as of November 3, 2006:

<b>Area/Block</b>	<b>WI</b>	<b>NRI</b>	<b>Status</b>
<i>Contango Operators, Inc:</i>			
Eugene Island 10	(8)	(8)	Discovery
High Island A-279	(9)	(9)	Determined to be a dry hole
<i>Republic Exploration LLC:</i>			
Eugene Island 10	(8)	(8)	Discovery

- (8) COI has a 35% WI through completion, an 18.3% WI after completion, and a 13.75% WI following a farmor back-in of 25%. COI will be awarded the lease on a produce-to-earn basis. REX has a 15% WI through completion, a 65.0% WI after completion, and a 48.75% WI following a farmor back-in of 25%.
- (9) COI has a 46.7% WI before casing point and a 37.5% working interest after casing point.



**Table of Contents**

*Leases.* The following table sets forth the working interests owned by Contango and related entities in the Gulf of Mexico as of November 3, 2006:

<b>Area/Block</b>	<b>WI</b>	<b>Lease Date</b>
<i>Contango Operators, Inc.:</i>		
West Cameron 174	10.0%	Jul-03
Grand Isle 63	25.0%	May-04
Grand Isle 72	25.0%	May-04
Grand Isle 73	25.0%	May-04
West Delta 43	35.0%	May-04
High Island A279	37.5%	Jan-06
Ship Shoal 14	37.5%	May-06
Ship Shoal 25	37.5%	May-06
South Marsh Island 57	37.5%	May-06
South Marsh Island 59	37.5%	May-06
South Marsh Island 75	37.5%	May-06
South Marsh Island 282	37.5%	May-06
Grand Isle 70	36.5%	Jun-06
West Delta 77	25.0%	Jun-06
Vermilion 194	37.5%	Jul-06
<b>Area/Block</b>	<b>WI</b>	<b>Lease Date</b>
<i>Republic Exploration LLC:</i>		
West Cameron 174	90.0%	Jul-03
High Island 113	100.0%	Oct-03
South Timbalier 191	50.0%	May-04
Vermilion 36	100.0%	May-04
Vermilion 109	100.0%	May-04
Vermilion 134	100.0%	May-04
West Cameron 179	100.0%	May-04
West Cameron 185	100.0%	May-04
West Cameron 200	100.0%	May-04
West Delta 18	100.0%	May-04
West Delta 33	100.0%	May-04
West Delta 34	100.0%	May-04
West Delta 43	30.0%	May-04
Ship Shoal 220	50.0%	Jun-04
South Timbalier 240	50.0%	Jun-04
West Cameron 133	100.0%	Jun-04
West Cameron 80	100.0%	Jun-04
West Cameron 167	100.0%	Jun-04
Vermilion 130	100.0%	Jul-04
West Cameron 107	100.0%	May-05
Eugene Island 168	50.0%	Jun-05
S-L 18640 (LA)	65.0%	Jul-05
S-L 18860 (LA)	65.0%	Jan-06
South Marsh Island 57	50.0%	May-06
South Marsh Island 59	50.0%	May-06
South Marsh Island 75	50.0%	May-06
South Marsh Island 282	50.0%	May-06
Ship Shoal 14	50.0%	May-06
Ship Shoal 25	50.0%	May-06
West Delta 77	50.0%	Jun-06
Vermilion 194	50.0%	Jul-06
High Island A196	100.0%	Oct-06
High Island A197	100.0%	Oct-06



**Table of Contents**

<b>Area/Block</b>	<b>WI</b>	<b>Lease Date</b>
<i>Contango Offshore Exploration LLC:</i>		
Viosca Knoll 75	33.3%	May-02
Viosca Knoll 167	100.0%	May-03
Vermilion 231	100.0%	May-03
Viosca Knoll 161	33.3%	Jul-03
Eugene Island 209	100.0%	Jul-03
High Island A16	100.0%	Dec-03
East Breaks 283	100.0%	Dec-03
South Timbalier 191	50.0%	May-04
Grand Isle 63	50.0%	May-04
Grand Isle 72	50.0%	May-04
Grand Isle 73	50.0%	May-04
Ship Shoal 220	50.0%	Jun-04
South Timbalier 240	50.0%	Jun-04
Viosca Knoll 118	33.3%	Jun-04
Viosca Knoll 475	100.0%	May-05
Eugene Island 168	50.0%	Jun-05
East Breaks 366	100.0%	Nov-05
East Breaks 410	100.0%	Nov-05
Ship Shoal 263	75.0%	Jun-06
Grand Isle 70	52.6%	Jun-06
Viosca Knoll 119	50.0%	Jun-06
Viosca Knoll 383	100.0%	Jun-06
<b>Area/Block</b>	<b>WI</b>	<b>Lease Date</b>
<i>Magnolia Offshore Exploration LLC:</i>		
Ship Shoal 155	100.0%	May-02
Viosca Knoll 75	16.7%	May-02
Viosca Knoll 161	16.7%	Jul-03
Viosca Knoll 118	16.7%	Jun-04
Viosca Knoll 211	100.0%	Jul-04

**Freeport LNG Development, L.P.**

As of September 30, 2006, the Company has invested \$3.2 million and owns a 10% limited partnership interest in Freeport LNG Development, L.P. ( Freeport LNG ), a limited partnership formed to develop, construct and operate a 1.5 billion cubic feet per day ( Bcf/d ) liquefied natural gas ( LNG ) receiving terminal in Freeport, Texas.

In July 2004, Freeport LNG finalized its transaction with ConocoPhillips for the financing, construction and use of the LNG receiving terminal in Freeport, Texas. ConocoPhillips executed a terminal use agreement for 1.0 Bcf/d of regasification capacity, purchased a 50% interest in the general partner managing the Freeport LNG project and agreed to provide construction funding to the venture. This construction funding will be non-recourse to Contango. The Dow Chemical Company ( Dow Chemical ) has also executed a terminal use agreement for regasification capacity of 500 million cubic feet per day ( MMcf/d ) and, in an unrelated transaction with another limited partner, has purchased a 15% limited partnership interest in Freeport LNG. Freeport LNG is responsible for the commercial activities of the partnership, while the general partners, Freeport LNG and ConocoPhillips manage the entire project and ConocoPhillips, under a construction advisory and management agreement, is managing the construction of the facility.

In January 2005, Freeport LNG received its authorization to commence construction of the first phase ( Phase I ) of its terminal from the Federal Energy Regulatory Commission (the FERC ) and construction of the 1.5 Bcf/d facility commenced on January 17, 2005. The terminal s Phase I capacity has been sold to ConocoPhillips (1.0 Bcf/d) and Dow Chemical Company (0.5 Bcf/d) and construction is expected to be completed by January 2008. The engineering, procurement and construction contractor is a consortium of Technip USA, Zachry Construction of San Antonio, and Saipem SpA of Italy.

**Table of Contents**

A majority of the Freeport LNG financing for Phase I is being provided by ConocoPhillips through a construction loan, with debt service being provided by the terminal use agreement with ConocoPhillips. Additional financing has been obtained through a \$383.0 million private placement note issuance by Freeport LNG which closed on December 19, 2005. The funds from the notes are being used to fund the balance of the Phase I construction of Freeport LNG's liquefied natural gas regasification terminal. The funds will also be used to fund the development of an integrated natural gas storage salt cavern and a portion of the cost of an expansion of the LNG terminal ( Phase II ). The notes are secured primarily by payments obligated under the terminal use agreement with Dow Chemical.

Phase II expansion of the LNG terminal may include a second LNG unloading dock, additional send-out and additional storage capacity. Freeport LNG submitted a permit application for the expansion to the FERC in May, 2005. FERC approved the expansion permit on September 21, 2006. Portions of the Phase II capacity have been sold to MC Global Gas Corporation, a wholly-owned subsidiary of Mitsubishi Corporation. Expansions of the terminal included in the current applications are planned and will be constructed as additional capacity is sold.

Although we anticipate that we may, from time-to-time, be required to provide funds to the Freeport LNG project, and intend to provide our pro rata 10% of any required equity participation, we believe the project will continue through Phase I construction and Phase II pre-development with no further significant funds likely being required from Contango.

**Contango Venture Capital Corporation**

As of September 30, 2006, Contango Venture Capital Corporation ( CVCC ), our wholly-owned subsidiary, held a direct investment in three alternative energy portfolio companies Trulite, Inc. ( Trulite ), Gridpoint, Inc. ( Gridpoint ) and Mobilize Inc. ( Mobilize ). Our investment in each of Trulite and Gridpoint is less than 20% and we account for these investments under the cost method. Our investment in Mobilize rose above 20% during the three months ended September 30, 2006 when the Company exercised its right pursuant to two warrants, to purchase additional shares of the company. We now account for this investment under the equity method.

*Trulite, Inc.* As of September 30, 2006, CVCC had invested \$0.9 million in Trulite in exchange for 2,001,014 shares of Trulite common stock, which represents an approximate 17% ownership interest. Trulite develops lightweight hydrogen generators for fuel cell systems.

*Gridpoint, Inc.* As of September 30, 2006, CVCC had invested \$1.0 million in Gridpoint in exchange for 333,333 shares of Gridpoint preferred stock, which represents an approximate 1.8% ownership interest. Gridpoint's intelligent energy management products ensure clean, reliable power, increase energy efficiency, and integrate renewable energy. With Gridpoint, home and business owners can automatically protect themselves from power outages, manage their energy online and reduce their carbon footprint. Gridpoint's plug-and-play appliances are easy to install and are sold through a network of premium home builders, utilities, retail chains and government entities as well as installers and contractors of electrical, heating, air-conditioning, home automation, power quality and renewable energy systems.

*Mobilize Inc.* As of September 30, 2006, CVCC had invested \$1.2 million in Mobilize in exchange for 648,648 shares of Mobilize convertible preferred stock, which represents an approximate 33% ownership interest. Mobilize develops real time diagnostics and field optimization solutions for the oil and gas industry using open-standards based technologies. Mobilize is deploying its technology in oil fields near Houston belonging to Chevron U.S.A. Inc. and on our Grand Isle 72 development, which will allow COI to remotely monitor, control and record, in real time, daily production volumes.

In June 2004, CVCC acquired a 32% membership interest in Contango Capital Partnership Management,

**Table of Contents**

LLC ( CCPM ) for \$0.5 million. CVCC is the 25% limited partner of, and CCPM is the general partner of, Contango Capital Partners, L.P., which was formed in January 2005 for the purpose of investing in the energy venture capital market. Contango Capital Partners, L.P. then formed Contango Capital Partners Fund, L.P. (the Fund ).

On January 31, 2005, the Fund was closed to new investments with a total capitalization of \$8.2 million in the form of contributed stock, cash, and future cash commitments. Prior to CVCC holding a direct interest in Trulite and Moblize, the Fund previously held these investments. The Fund also had an investment in Synexus Energy, Inc. ( Synexus ). Synexus is a portable and stationary fuel cell integrator developing technology with a lightweight fuel cell stack that will create both portable and stationary power solutions for customers. In April 2006, Trulite acquired Synexus technology. In May 2006, the Fund distributed its pro rata shares of Trulite to CVCC. In June 2006, the Fund sold its investment in Moblize to CVCC for \$0.6 million.

As of September 30, 2006, CVCC owns 25% of the Fund. The Fund currently holds a direct investment in two alternative energy companies Protonex Technology Corporation ( Protonex ) and Jadoo Power Systems ( Jadoo ). We account for these investments under the equity method.

*Protonex Technology Corporation.* As of September 30, 2006, the Fund has invested \$1.5 million in Protonex in exchange for 2,400,000 shares of Protonex stock, which represents an approximate 7% ownership interest. Protonex provides long-duration portable and remote power sources with a focus on providing solutions to the U.S. military and supplies complete power solutions and application engineering services to original equipment manufacturers customers. During the period, Protonex began trading its common shares on the AIM market of the London Stock Exchange under the stock symbol PTX.L . As a result, the Fund marks-to-market its investment in Protonex based on public pricing. At September 30, 2006, the Fund s investment in Protonex had a mark-to-market value of approximately \$4.3 million.

*Jadoo Power Systems.* As of September 30, 2006, the Fund has invested approximately \$1.2 million and owns 2,200,000 shares of Jadoo stock, which represents an approximate 5% ownership interest. Jadoo develops high energy density power products for the law enforcement, military and electronic news gathering applications. As of September 30, 2006, the Fund s investment in Jadoo had a valuation of approximately \$1.2 million.

Since the Fund s inception, the Company has recorded a cumulative \$0.8 million increase to our investment resulting primarily from unrealized gains of the Fund as a result of mark-to-market adjustments that have been made due to the increase in the value of our alternative energy investments, bringing our total investment in alternative energy investments, including cumulative mark-to-market adjustments, as of September 30, 2006, to approximately \$5.1 million.

**Summary of Critical Accounting Policies**

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

*Successful Efforts Method of Accounting.* The accounting for our business is subject to special accounting rules that are unique to the oil and gas industry. There are two allowable methods of accounting for oil and gas business activities: the successful efforts method and the full-cost method. There are several significant differences between these methods. Under the successful efforts method, costs such as geological and geophysical, exploratory dry holes and delay rentals are expensed as incurred, where under the full-cost method these types of charges would be capitalized to their respective full-cost pool. In the measurement of impairment of oil and gas properties, the successful efforts method of accounting follows the guidance provided in SFAS 144, where the first measurement for impairment is to compare the net book value of the related asset to its undiscounted future cash flows using

**Table of Contents**

commodity prices consistent with management expectations. Under the full-cost method, the net book value (full-cost pool) is compared to the future net cash flows discounted at 10 percent using commodity prices in effect on the last day of the reporting period (ceiling limitation). If the full-cost pool is in excess of the ceiling limitation, the excess amount is charged through income.

We have elected to use the successful efforts method to account for our investment in oil and gas properties. Under the successful efforts method, lease acquisition costs and all development costs are capitalized. Unproved properties are reviewed quarterly to determine if there has been impairment of the carrying value, and any such impairment is charged to expense in the period. Exploratory drilling costs are capitalized until the results are determined. If proved reserves are not discovered, the exploratory drilling costs are expensed. Other exploratory costs, such as seismic costs and other geological and geophysical expenses, are expensed as incurred. The provision for depreciation, depletion and amortization is based on the capitalized costs as determined above. Depreciation, depletion and amortization is on a cost center by cost center basis using the unit of production method, with lease acquisition costs amortized over total proved reserves and other costs amortized over proved developed reserves.

When circumstances indicate that proved properties may be impaired, the Company compares expected undiscounted future cash flows on a cost center basis to the unamortized capitalized cost of the asset. If the future undiscounted cash flows, based on the Company's estimate of future natural gas and oil prices and operating costs and anticipated production from proved reserves, are lower than the unamortized capitalized cost, then the capitalized cost is reduced to fair market value. Our financial position and results of operations would have been significantly different had we used the full-cost method of accounting for our oil and gas investments. Generally, the application of the successful efforts method of accounting for oil and gas property results in lower capitalized costs and higher expenses compared to similar companies applying the full-cost method of accounting.

In accordance with SFAS 144, the Company classified its \$11.6 million property sale effective April 1, 2006, its property sale to an independent oil and gas company for \$2.0 million, effective February 1, 2006, and its property sale to Edge Petroleum Corporation ( Edge Petroleum ) for \$50.0 million, effective July 1, 2004, as discontinued operations. An integral and on-going part of our business strategy is to sell our proved reserves from time to time in order to generate additional capital to reinvest in our onshore and offshore exploration programs. Thus, it is our intent to remain an independent natural gas and oil company engaged in the exploration, production, and acquisition of natural gas and oil.

*Cash Equivalents.* Cash equivalents are considered to be highly liquid investment grade debt investments having an original maturity of 90 days or less. As of September 30, 2006, the Company had \$3,650,634 in cash and cash equivalents, of which \$2,097,485 was invested in highly liquid AAA-rated tax-exempt money market funds.

*Short Term Investments.* As of September 30, 2006, the Company had \$9,011,650 invested in a portfolio of periodic auction reset ( PAR ) securities, which have coupons that periodically reset to market interest rates at intervals ranging from 7 to 35 days. These PAR securities are being classified as short term investments and consist of AAA-rated tax-exempt municipal bonds. PAR securities are highly liquid and have minimal interest rate risk.

*Principles of Consolidation.* The Company's consolidated financial statements include the accounts of Contango Oil & Gas Company and its subsidiaries and affiliates, after elimination of all intercompany balances and transactions. Wholly-owned subsidiaries are fully consolidated. Exploration and development subsidiaries not wholly owned, such as 42.7% owned REX, 50% owned MOE, and 76.0% owned COE (see Offshore Gulf of Mexico Exploration Joint Ventures ), each as of September 30, 2006, are not controlled by the Company and are proportionately consolidated. By agreement, REX, MOE and COE have disproportionate allocations of their profits and losses among the owners. Accordingly, the Company determines its income or losses from the ventures based on a hypothetical liquidation determination of how increases or decreases in the book value of the ventures' net assets will ultimately affect the cash payments to the Company in the event of dissolution.

**Table of Contents**

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

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

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

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

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

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

**Table of Contents**

In September 2006, the Securities and Exchange Commission staff issued Staff Accounting Bulletin ( SAB ) No. 108, incorporated into the SEC Rules and Regulations as Section N to Topic 1, Financial Statements, which provides guidance concerning the effects of prior year misstatements in quantifying current year misstatements for the purpose of materiality assessments. Specifically, entities must consider the effects of prior year unadjusted misstatements when determining whether a current year misstatement will be considered material to the financial statements at the current reporting period and record the adjustment, if deemed material. SAB No. 108 becomes effective for the first fiscal year ending after November 15, 2006, with adoption in the first interim period of that year encouraged. Upon adoption, entities may either restate the financial statements for each period presented or record the cumulative effect of the error correction as an adjustment to the opening balance of retained earnings at the beginning of the period of adoption, and provide disclosure of each individual error being corrected within the cumulative adjustment, stating when and how each error arose and the fact that the error was previously considered immaterial. We do not expect this authoritative guidance to have a material impact on our financial position, results of operations and cash flows.

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

*Stock-Based Compensation*. Effective July 1, 2001, the Company adopted the fair value based method prescribed in SFAS No. 123, *Accounting for Stock Based Compensation*. Under the fair value based method, compensation cost is measured at the grant date based on the fair value of the award and is recognized over the award vesting period. The fair value of each award is estimated as of the date of grant using the Black-Scholes options-pricing model. Effective July 1, 2005, the Company adopted SFAS No. 123 (revised 2004) ( SFAS 123(R) ), *Share-Based Payment*. Prior to the adoption of SFAS 123(R), the Company presented all benefits from the exercise of share-based compensation as operating cash flows in the statement of cash flows. SFAS 123(R) requires the benefits of tax deduction in excess of the compensation cost recognized for the options (excess tax benefit) to be classified as financing cash flows. The fair value of each option is estimated as of the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants during the quarters ended September 30, 2006 and 2005, respectively: (i) risk-free interest rate of 4.56 percent and 4.10 percent; (ii) expected lives of five years; (iii) expected volatility of 40 percent and (iv) expected dividend yield of zero percent.

Under the Company's 1999 Stock Incentive Plan, as amended (the 1999 Plan), the Company's Board of Directors may also grant restricted stock awards to officers or other employees of the Company. Restricted stock awards made under the 1999 Plan are subject to such restrictions, terms and conditions, including forfeitures, if any, as may be determined by the Board. Restricted stock awards generally vest over a period of three years. Grants of service based restricted stock awards are valued at our common stock price at the date of grant. During the three months ended September 30, 2006, the Company granted 16,750 shares of restricted stock to its employees.

During the three months ended September 30, 2006 and 2005, the Company recorded stock-based compensation charges of \$229,160 and \$177,939, respectively, to general and administrative expense.



**Table of Contents****MD&A Summary Data**

The table below sets forth revenue, expense and production data for both continuing and discontinued operations for the three months ended September 30, 2006 and 2005.

	Three Months Ended September 30,		
	2006	2005 (\$000)	Change
<b>Revenues:</b>			
Natural gas and oil sales	\$ 1,192	\$ 1,191	*
Total revenues	\$ 1,192	\$ 1,191	*
<b>Production:</b>			
Natural gas (million cubic feet)	144	91	58%
Oil and condensate (thousand barrels)	4	6	-33%
Total (million cubic feet equivalent)	168	127	32%
Natural gas (million cubic feet per day)	1.6	1.0	60%
Oil and condensate (thousand barrels per day)	0.1	0.1	*
Total (million cubic feet equivalent per day)	2.2	1.6	38%
<b>Average Sales Price:</b>			
Natural gas (per thousand cubic feet)	\$ 6.25	\$ 8.86	-29%
Oil and condensate (per barrel)	\$ 70.21	\$ 63.61	10%
Operating expenses	\$ 133	\$ (209)	-164%
Exploration expenses	\$ 401	\$ 339	18%
Depreciation, depletion and amortization	\$ 212	\$ 277	-23%
General and administrative expenses	\$ 1,103	\$ 922	20%
Interest expense (net of interest capitalized)	\$ 167	\$	100%
Interest income	\$ 252	\$ 209	21%
Other income	\$ 84	\$ 233	-64%

\* not meaningful

**Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005**

*Natural Gas and Oil Sales.* We reported revenues of approximately \$1.2 million for the three months ended September 30, 2006 and the three months ended September 30, 2005. Production from the properties that were sold subsequent to September 30, 2005 was replaced with production from our Arkansas Fayetteville Shale play and our offshore production from Eugene Island 79 and Eugene Island 113B. Of the \$1.2 million of natural gas and oil sales for the three months ended September 30, 2005, \$0.2 million relates to continuing operations.

For the three months ended September 30, 2006, prices for natural gas and oil were \$6.25 per Mcf and \$70.21 per barrel, compared to \$8.86 per Mcf and \$63.61 per barrel for the three months ended September 30, 2005.

*Natural Gas and Oil Production and Average Sales Prices.* Our net natural gas production for the three months ended September 30, 2006 was approximately 1.6 MMcf/d of natural gas, up from approximately 1.0 MMcf/d of natural gas for the three months ended September 30, 2005. Net oil production for the comparable periods decreased from 66 barrels of oil per day to 44 barrels of oil per day. The increase in natural gas production is principally attributable to our Arkansas Fayetteville Shale play wells, which are mainly gas wells. The decrease in oil production is principally attributable to the sale of our oil and gas wells subsequent to September 30, 2005.

---

**Table of Contents**

*Operating Expenses.* Lease operating expenses for the three months ended September 30, 2006 were \$132,949. Operating expenses from continuing operations for the three months ended September 30, 2005 were \$164,380. Total operating expenses for the three months ended September 30, 2005 resulted in a net credit of \$208,750. The Railroad Commission of Texas has extended a natural gas incentive allowing for severance tax reduction on tight sand gas wells. As a result, some of our previously sold south Texas properties are eligible for severance tax reduction. The \$373,130 credit for three months ended September 30, 2005 was attributable to previously paid severance taxes from our previously sold south Texas properties. Of the net credit of \$208,750 of operating expenses for the three months ended September 30, 2005, \$5,749 relates to continuing operations.

*Exploration Expense.* We reported \$401,347 of exploration expenses for the three months ended September 30, 2006. Of this amount, approximately \$758,777 was attributable to the cost of various geological and geophysical activities, seismic data, and delay rentals, offset by a credit of \$357,430. We reported \$339,438 of exploration expenses for the three months ended September 30, 2005. Of this amount, approximately \$256,119 was related to unsuccessful wells drilled in south Texas during the period and \$83,319 was attributable to the cost to acquire and reprocess 3-D seismic data. The entire \$339,438 of exploration expenses for the three months ended September 30, 2005 relates to continuing operations.

*Depreciation, Depletion and Amortization.* Depreciation, depletion and amortization for the three months ended September 30, 2006 was approximately \$212,191. For the three months ended September 30, 2005, we recorded \$277,084 of depreciation, depletion and amortization. The \$64,893 decrease is primarily the result of the sale of substantially all of our producing south Texas and Alabama properties in fiscal year 2006, partially offset by production from our Arkansas Fayetteville Shale play. Of the \$277,084 of depreciation, depletion and amortization for the three months ended September 30, 2005, \$55,360 relates to continuing operations.

*General and Administrative Expenses.* General and administrative expenses for the three months ended September 30, 2006 and the three months ended September 30, 2005 were approximately \$1.1 million and \$0.9 million, respectively. The entire \$0.9 million of general and administrative expenses for the three months ended September 30, 2005 relates to continuing operations.

Major components of general and administrative expenses for the three months ended September 30, 2006 included approximately \$0.5 million in salaries and benefits, \$0.1 million in legal, accounting, engineering and other professional fees, \$0.2 million in office administration expenses, \$0.1 million in insurance costs, and \$0.2 million related to the cost of expensing stock options and stock grant compensation.

Major components of general and administrative expenses for the three months ended September 30, 2005 included approximately \$0.3 million in salaries and benefits, \$0.1 million in legal, accounting, engineering and other professional fees, \$0.2 million in office administration expenses, \$0.1 million in insurance, and \$0.2 million related to the cost of expensing stock options.

*Interest Income.* We reported interest income of \$251,659 for the three months ended September 30, 2006. This compares to the \$209,053 of interest income reported for the three months ended September 30, 2005. The slight increase is due to the higher average levels of cash and cash equivalents and short term investments, further enhanced by higher interest rates.

*Other Income.* For the three months ended September 30, 2006, we reported other income of \$84,391 resulting from changes in the market value of Protonex and equity earnings from Mobilize. For the three months ended September 30, 2005, we reported other income from partially owned subsidiaries of \$209,522 and a gain of \$23,598 resulting from discontinued operations.

**Table of Contents****Production, Prices, Operating Expenses, and Other**

	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
	(Dollar amounts in 000 s,	
	except per Mcfe amounts)	
<b>Production Data:</b>		
Natural gas (million cubic feet)	144	91
Oil and condensate (thousand barrels)	4	6
Total (million cubic feet equivalent)	168	127
Natural gas (million cubic feet per day)	1.6	1.0
Oil and condensate (thousand barrels per day)	0.1	0.1
Total (million cubic feet equivalent per day)	2.2	1.6
Average sales price:		
Natural gas (per thousand cubic feet)	\$ 6.25	\$ 8.86
Oil and condensate (per barrel)	\$ 70.21	\$ 63.61
Selected data per Mcfe:		
Production and severance taxes	\$ 0.27	\$ (2.42)
Lease operating expenses	\$ 0.52	\$ 0.78
General and administrative expenses	\$ 6.54	\$ 7.25
Depreciation, depletion and amortization of natural gas and oil properties	\$ 1.00	\$ 2.07
EBITDAX (1)	\$ 39	\$ 734

- (1) EBITDAX represents earnings before interest, income taxes, depreciation, depletion and amortization, impairment expenses, exploration expenses, including gain (loss) from hedging activities, and sale of assets and other. We have reported EBITDAX because we believe EBITDAX is a measure commonly reported and widely used by investors as an indicator of a company's operating performance and ability to incur and service debt. We believe EBITDAX assists investors in comparing a company's performance on a consistent basis without regard to depreciation, depletion and amortization, impairment of natural gas and oil properties and exploration expenses, which can vary significantly depending upon accounting methods. EBITDAX is not a calculation based on U.S. generally accepted accounting principles and should not be considered an alternative to net income (loss) in measuring our performance or used as an exclusive measure of cash flow because it does not consider the impact of working capital growth, capital expenditures, debt principal reductions and other sources and uses of cash, which are disclosed in our statements of cash flows. Investors should carefully consider the specific items included in our computation of EBITDAX. While we have disclosed our EBITDAX to permit a more complete comparative analysis of our operating performance and debt servicing ability relative to other companies, investors should be cautioned that EBITDAX as reported by us may not be comparable in all instances to EBITDAX as reported by other companies. EBITDAX amounts may not be fully available for management's discretionary use, due to requirements to conserve funds for capital expenditures, debt service, preferred stock dividends and other commitments.

**Table of Contents**

A reconciliation of EBITDAX to loss from operations and operating results for discontinued operations for the periods indicated is presented below.

	Three Months Ended September 30,	
	2006	2005
	(\$000)	
Loss from continuing operations	\$ (658)	\$ (1,175)
Exploration expenses	401	339
Depreciation, depletion and amortization	212	55
Other income	84	210
<b>EBITDAX from continuing operations</b>	<b>39</b>	<b>(571)</b>
Income from discontinued operations before taxes		1,059
Depreciation, depletion and amortization		222
Other income		24
<b>EBITDAX</b>	<b>\$ 39</b>	<b>\$ 734</b>

**Capital Resources and Liquidity**

*Cash Inflow.* During the three months ended September 30, 2006, we had \$16.3 million of cash inflow consisting of internally generated after-tax net cash flow from operations of \$6.8 million and \$9.5 million from the sale of short term investments.

*Cash Outflow.* During the three months ended September 30, 2006, we used a total of \$22.9 million of cash consisting of \$22.0 million in exploration and development activities (approximately \$13.0 million offshore and \$9.0 million onshore), \$0.6 million in alternative energy companies and \$0.3 million in financing activities.

*Capital Budget.* For the remaining nine months of fiscal year 2007, our capital expenditure budget calls for us to invest a total of \$54.4 million (\$4.4 million of this was invested in October 2006), as we continue to invest in our Arkansas Fayetteville Shale play, bring our Grand Isle 72 ( Liberty ) and Eugene Island 10 ( Dutch ) discoveries to production and spud a second exploration well at our Dutch prospect in December 2006.

Of the \$54.4 million in capital expenditures budgeted for the remaining nine months of fiscal year 2007, \$13.8 million is anticipated to be invested in offshore activities. Our budget calls for us to invest approximately \$2.2 million for production and pipeline facilities for developing Grand Isle 72, approximately \$4.4 million for completion, production and pipeline facilities for developing our first well at Eugene Island 10 (\$2.2 million was invested in October 2006), approximately \$3.7 million for drilling our second well at Eugene Island 10, \$3.0 million in other exploratory wells and \$0.5 million in projected future exploration costs, seismic and delay rentals.

Of the \$54.4 million in capital expenditures budgeted for the remaining nine months of fiscal year 2007, \$40.1 million is expected to be invested in onshore activities. In the Arkansas Fayetteville Shale, our partners and we have acquired or received commitments on approximately 44,300 net mineral acres and we have committed to a total of 87 wells in this play as of October 31, 2006. We have an average working interest of 15% and a net revenue interest of 12% in these 87 wells. Of these 87 wells, 19 are operated by Alta and 68 are operated by a third party independent oil and gas exploration company (these 68 wells are referred to as Integrated Wells ).

Of the 19 Alta wells, two were drilled in fiscal year 2006 and five have been drilled thus far during fiscal year 2007. We estimate an additional \$6.3 million, net to Contango, will be required for remaining drilling.

**Table of Contents**

frac, completion and hook-up costs of these seven wells (\$1.6 million of this was invested in October 2006). We are budgeting to drill an additional ten new Alta wells during fiscal year 2007 at a cost of \$14.4 million. This includes drilling, frac, completion and hookup costs for the wells. Additionally, we expect to invest \$7.6 million in pipeline infrastructure, seismic and additional leasehold costs for the Arkansas Fayetteville Shale. We estimate we will have an average working interest of 42% and a net revenue interest of 33% in these 19 Alta wells.

Of the 68 Integrated Wells for which we have received AFEs, 22 wells are producing, 20 wells have already been spud, and 26 wells have yet to be drilled. In addition to these 68 Integrated Wells, we are budgeting to receive 56 additional AFEs for Integrated Wells during the remainder of fiscal year 2007 for a total of 124 Integrated Wells. We anticipate having approximately 40 producing Integrated Wells by December 2006. Our capital budget for Integrated Wells assumes we will invest \$10.8 million in Integrated Wells during the remainder of fiscal year 2007 (\$0.6 million of this was invested in October 2006). We estimate we will have an average working interest of 6% and a net revenue interest of 5% in these 124 Integrated Wells.

Our capital budget also calls for us to invest approximately \$1.0 million with Alta in an onshore prospect in Alabama, and loaning an additional \$500,000 to Trulite.

Freeport LNG closed a \$383.0 million private placement note issuance in December 2005, and we believe the LNG project will continue through Phase I construction and Phase II pre-development expansion with no further significant funds being required from Contango.

As of November 3, 2006, we have approximately \$12.7 million in cash, cash equivalents, and short term investments and \$20.0 million in long-term debt outstanding. The Company had estimated production during October 2006 of approximately 1.5 MMcfe/d.

We will need additional financing to supplement our internally generated cash flow to fund our offshore exploration and development and Arkansas Fayetteville Shale development programs. We intend to access our additional funding needs by first seeking a hydrocarbon borrowing base bank loan. Depending on the terms, conditions and amount of traditional bank financing made available to us, we may be further required to pursue mezzanine debt, equity financing, the sale of assets or seek other financing to fund our opportunities. The availability of such funds will depend upon prevailing market conditions and other factors over which we have no control, as well as our financial condition and results of operations.

**Natural Gas and Oil Reserves**

The following table presents our estimated net proved, developed producing natural gas and oil reserves and the pre-tax net present value of our reserves at September 30, 2006. Our onshore reserves were based on a reserve report generated by W.D. Von Gonten & Co. The offshore reserves were based on a reserve report generated by William M. Cobb & Associates, Inc. The pre-tax net present value is not intended to represent the current market value of the estimated natural gas and oil reserves we own.

The pre-tax net present value of future cash flows attributable to our proved reserves as of September 30, 2006 was determined by the September 30, 2006 prices of \$4.18 per MMBtu for natural gas at the Houston Ship Channel and \$62.91 per barrel of oil at West Texas Intermediate Posting, in each case before adjustments.

	<b>Proved</b>
	<b>Reserves as of</b>
	<b>September 30, 2006</b>
Natural Gas (MMcf)	29,238
Oil and Condensate (MBbls)	685
Total proved reserves (Mmcfe)	33,348
Pre-tax net present value, SEC guidelines (\$000)	\$ 102,437

---

**Table of Contents**

The process of estimating natural gas and oil reserves is complex. It requires various assumptions, including natural gas and oil prices, drilling and operating expenses, capital expenditures, taxes and availability of funds. Our third party engineers must project production rates and timing of development expenditures, as well as analyze available geological, geophysical, production and engineering data. The extent, quality and reliability of this data can vary. Therefore, estimates of natural gas and oil reserves are inherently imprecise. Actual future production, natural gas and oil prices, revenues, taxes, development expenditures, operating expenses and quantities of recoverable natural gas and oil reserves most likely will vary from estimates. Any significant variance could materially affect the estimated quantities and net present value of reserves. In addition, our third party engineers may adjust estimates of proved reserves to reflect production history, results of exploration and development, prevailing natural gas and oil prices and other factors, many of which are beyond our control. Because most of our reserve estimates are not based on a lengthy production history and are calculated using volumetric analysis, these estimates are less reliable than estimates based on a lengthy production history.

It should not be assumed that the pre-tax net present value is the current market value of our estimated natural gas and oil reserves. In accordance with requirements of the Securities and Exchange Commission, we base the estimated discounted future net cash flows from proved reserves on prices and costs available on the date of the estimate. Actual future prices and costs may differ materially from those used in the present value estimate.

**Credit Facility**

On April 27, 2006 the Company completed the arrangement of a new three-year \$20.0 million secured term loan agreement with The Royal Bank of Scotland plc ( RBS ). The term loan agreement is secured with the stock of Contango Sundance, Inc. ( Sundance ), our wholly-owned subsidiary. Sundance owns a 10% limited partnership interest in Freeport LNG Development, LP, which owns the Freeport LNG facility. As of November 3, 2006, the Company has borrowed the entire \$20.0 million under the term loan agreement. Borrowings under the Agreement bear interest, at the Company's option, at either (i) 30 day LIBOR, (ii) 60 day LIBOR or (iii) 90 day LIBOR, all plus 6.5%. Interest is due at the end of the LIBOR period chosen. The principal is due April 27, 2009, but we may prepay after April 27, 2008 with no prepayment penalty.

The term loan agreement requires the maintenance of certain ratios, including those related to working capital, as defined in the term loan agreement. Additionally, the term loan agreement contains certain negative covenants that, among other things, restrict or limit our ability to incur indebtedness, sell certain assets, and pay dividends. Failure to maintain required financial ratios or comply with the term loan agreement's covenants could result in a default and acceleration of all indebtedness under the credit facility. As of November 3, 2006, the Company was in compliance with its financial covenants, ratios and other provisions of the term loan agreement.

The Company's credit facility with Guaranty Bank, FSB is an unsecured \$100,000 revolving line of credit. Although the Company has no borrowings against this line as of September 30, 2006, the revolving line of credit is being maintained and matures on June 29, 2008. Borrowings under the credit facility bear interest, at the Company's option, at either (i) LIBOR plus two percent (2%) or (ii) the bank's base rate plus one-fourth percent (1/4%) per annum. Additionally, the Company pays a quarterly commitment fee of three-eighths percent (3/8%) per annum on the average availability.

The hydrocarbon borrowing base is subject to semi-annual redetermination based primarily on the value of our proved reserves. The credit facility requires the maintenance of certain ratios, including those related to working capital, funded debt to EBITDAX, and debt service coverage, as defined in the credit agreements. Additionally, the credit agreements contain certain negative covenants that, among other things, restrict or limit our ability to incur indebtedness, sell assets, pay dividends and reacquire or otherwise acquire or redeem capital stock. Failure to maintain required financial ratios or comply with the credit facility's covenants can result in a default and acceleration of all indebtedness under the credit facility. As of November 3, 2006, the Company was in compliance with its financial covenants, ratios and other provisions of its credit facility.

## **Table of Contents**

### **Risk Factors**

*In addition to the other information set forth elsewhere in this Form 10-Q and in our annual report on Form 10-K, you should carefully consider the following factors when evaluating the Company. An investment in the Company is subject to risks inherent in our business. The trading price of the shares of the Company is affected by the performance of our business relative to, among other things, competition, market conditions and general economic and industry conditions. The value of an investment in the Company may decrease, resulting in a loss. The risk factors listed below are not all inclusive.*

***We have outsourced the marketing of our production and have no ability to control the prices that we receive for natural gas and oil. Natural gas and oil prices fluctuate widely, and low prices would have a material adverse effect on our revenues, profitability and growth.***

Our revenues, profitability and future growth will depend significantly on natural gas and crude oil prices. Prices received also will affect the amount of future cash flow available for capital expenditures and repayment of indebtedness and will affect our ability to raise additional capital. Lower prices may also affect the amount of natural gas and oil that we can economically produce. Factors that can cause price fluctuations include:

The domestic and foreign supply of natural gas and oil.

Overall economic conditions.

The level of consumer product demand.

Adverse weather conditions and natural disasters.

The price and availability of competitive fuels such as heating oil and coal.

Political conditions in the Middle East and other natural gas and oil producing regions.

The level of LNG imports.

Domestic and foreign governmental regulations.

Potential price controls and special taxes.

***We depend on the services of our chairman, chief executive officer and chief financial officer, and implementation of our business plan could be seriously harmed if we lost his services.***

We depend heavily on the services of Kenneth R. Peak, our chairman, chief executive officer, and chief financial officer. We do not have an employment agreement with Mr. Peak, and the proceeds from a \$10.0 million key person life insurance policy on Mr. Peak may not be adequate to cover our losses in the event of Mr. Peak's death.

***We are highly dependent on the technical services provided by our alliance partners and could be seriously harmed if our alliance agreements were terminated.***

## Edgar Filing: CONTANGO OIL & GAS CO - Form 10-Q

Because we have only six employees, none of whom are geoscientists or petroleum engineers, we are dependent upon alliance partners for the success of our natural gas and oil exploration projects and expect to remain so for the foreseeable future. Highly qualified explorationists and engineers are difficult to attract and retain. As a result, the loss of the services of one or more of our alliance partners could have a material adverse effect on us and could prevent us from pursuing our business plan. Additionally, the loss by our alliance partners of certain explorationists could have a material adverse effect on our operations as well.



---

**Table of Contents*****Our ability to successfully execute our business plan is dependent on our ability to obtain adequate financing.***

Our business plan, which includes participation in 3-D seismic shoots, lease acquisitions, the drilling of exploration prospects and producing property acquisitions, has required and will require substantial capital expenditures. We may require additional financing to fund our planned growth. Our ability to raise additional capital will depend on the results of our operations and the status of various capital and industry markets at the time we seek such capital. Accordingly, we cannot be certain that additional financing will be available to us on acceptable terms, if at all. In particular, our credit facility imposes limits on our ability to borrow under the facility based on adjustments to the value of our hydrocarbon reserves, and our credit facility limits our ability to incur additional indebtedness. In the event additional capital resources are unavailable, we may be required to curtail our exploration and development activities or be forced to sell some of our assets in an untimely fashion or on less than favorable terms.

***We lack experience as Operator in drilling high pressure wells in the Gulf of Mexico.***

Contango Operators, Inc. ( COI ) is a wholly-owned subsidiary of the Company, formed for the purpose of drilling and operating exploration wells in the Gulf of Mexico and is a recent addition to our business strategy. COI is currently the operator for our exploration prospect at Eugene Island 10. Although as a company we have previously taken working interests in offshore prospects, our recent exploration prospects are the first wells in which we have assumed the role of operator. Estimated drilling costs could be significantly higher if we encounter difficulty in drilling offshore exploration wells.

Drilling activities are subject to numerous risks, including the risk that no commercially productive hydrocarbon reserves will be encountered. The cost of drilling, completing and operating wells and of installing production facilities and pipelines is often uncertain. The Company's drilling operations may be curtailed, delayed, canceled or negatively impacted as a result of numerous factors, including inexperience as an operator, title problems, weather conditions, compliance with governmental requirements and shortages or delays in the delivery or availability of material, equipment and fabrication yards. In periods of increased drilling activity resulting from high commodity prices, demand exceeds availability for drilling rigs, drilling vessels, supply boats and personnel experienced in the oil and gas industry in general, and the offshore oil and gas industry in particular. This may lead to difficulty and delays in consistently obtaining certain services and equipment from vendors, obtaining drilling rigs and other equipment at favorable rates and scheduling equipment fabrication at factories and fabrication yards. This, in turn, may lead to projects being delayed or experiencing increased costs. The cost of drilling, completing, and operating wells is often uncertain, and we cannot assure that new wells will be productive or that we will recover all or any portion of our investment. The risk of significant cost overruns, curtailments, delays, inability to reach our target reservoir and other factors detrimental to drilling and completion operations may be higher due to our inexperience as an operator.

***We may have excessive resources committed to our Arkansas Fayetteville Shale Play.***

Since inception, we have invested approximately \$15.6 million in our Arkansas Fayetteville Shale play including \$5.4 million invested during the three months ended September 30, 2006. Our capital budget for the remainder of fiscal year 2007 calls for us to invest an additional \$29.0 million in the Arkansas Fayetteville Shale. This represents approximately 75% of our total CAPEX budget for the remainder of fiscal year 2007. We intend to borrow significant capital against anticipated revenues and production, and should the wells not perform as expected, we will likely encounter difficulty repaying this debt. There can be no assurance that our drilling activity in this area will produce economically feasible wells. It is early in the exploration and development of this play and we are still learning how to drill, complete, frac and produce these wells. Additionally, all of our wells are operated by outside companies. As a result, we have a limited ability to exercise influence over operations or their associated costs and risks.

---

**Table of Contents**

***Increasing capital investment in certain prospects increases our dry hole risk exposure.***

Beginning in the spring of 2005, we decided to increase our capital investment in certain exploration prospects, including our onshore Arkansas Fayetteville Shale prospect and our offshore Gulf of Mexico prospects. From July 1, 2005 through October 31, 2006, we have invested, or committed to invest, approximately \$27.0 million in our offshore prospects, and \$22.5 million in the Arkansas Fayetteville Shale. This represents a major increase in the risk profile of the Company which in the past has limited its dry hole risk exposure on any one well to approximately \$1.0 million.

***The construction of our LNG receiving terminal in Freeport, Texas is subject to various development and completion risks.***

We own a 10% limited partnership interest in the Freeport LNG receiving facility that is being constructed in Freeport, Texas. The LNG project received approval from the Federal Energy Regulatory Commission (the "FERC") in June 2004. On January 11, 2005, Freeport LNG received its authorization to commence construction of the first phase of its terminal from the FERC. Construction of the 1.5 Bcf/d facility commenced on January 17, 2005. Freeport LNG is seeking an additional order from the FERC that would authorize the construction of an expansion that would increase the capacity at its currently permitted 1.5 Bcf/d Freeport LNG terminal to 2.6 Bcf/d. The LNG receiving facility is subject to development risk such as permitting, cost overruns and delays. Key factors that may affect the completion of the LNG receiving terminal include, but are not limited to: timely issuance of necessary additional permits, licenses and approvals by governmental agencies and third parties; sufficient financing; unanticipated changes in market demand or supply; competition with similar projects; labor disputes; site difficulties; environmental conditions; unforeseen events, such as hurricanes, explosions, fires and product spills; delays in manufacturing and delivery schedules of critical equipment and materials; resistance in the local community; local and general economic conditions; and commercial arrangements for pipelines and related equipment to transport and market LNG.

If completion of the LNG receiving facility is delayed beyond the estimated development period, the actual cost of completion may increase beyond the amounts currently estimated in our capital budget. A delay in completion of the LNG receiving facility would also cause a delay in the receipt of revenues projected from operation of the facility, which may cause our business, results of operations and financial condition to be substantially harmed.

***If we are not able to fund or finance our 10% ownership in the LNG receiving facility in Freeport, Texas, including any expansion of the facility, we may lose our 10% investment in the project.***

A majority of the Freeport LNG financing is being provided by ConocoPhillips through a \$620.0 million construction loan, with debt service being provided by the terminal use agreement with ConocoPhillips. Additional financing has been obtained through a \$383.0 million private placement note issuance by Freeport LNG which closed on December 19, 2005. The notes are secured primarily by payments obligated under the terminal use agreement with Dow Chemical. Upon any significant increase in construction costs to complete construction of the receiving facility or upon a call to fund construction of the proposed expansion, we may not have the financial resources to fund our 10% ownership share of construction costs. If we are unable to fund our share of the project costs or if the project is unable to secure third-party project financing, we could lose our investment in the project or be forced to sell our interest in an untimely fashion or on less than favorable terms.

***If we default on our Sundance loan we could lose our 10% investment in the LNG receiving facility in Freeport, Texas.***

Our three-year \$20.0 million term loan agreement dated April 27, 2006 with The Royal Bank of Scotland plc is secured with the stock of Contango Sundance, Inc. ("Sundance"), our wholly-owned subsidiary. Sundance owns a 10% limited partnership interest in Freeport LNG Development, LP, which owns the Freeport LNG facility. If an event of default occurs under the term loan agreement, we could lose our investment in the Freeport LNG facility.

## **Table of Contents**

***If REX cannot promptly repay the REX Note upon demand by the lender, REX could lose all of its assets, including its interest in the Eugene Island 10 discovery in the Gulf of Mexico.***

The REX Note is payable upon the earlier of a demand by the lender and October 26, 2007 and is secured by substantially all of the assets of REX. If the lender were to demand repayment and REX were unable to access funds for repayment, REX could lose all the collateral securing the REX Note.

***Natural gas and oil reserves are depleting assets and the failure to replace our reserves would adversely affect our production and cash flows.***

Our future natural gas and oil production depends on our success in finding or acquiring new reserves. If we fail to replace reserves, our level of production and cash flows would be adversely impacted. Production from natural gas and oil properties decline as reserves are depleted, with the rate of decline depending on reservoir characteristics. Our total proved reserves will decline as reserves are produced unless we conduct other successful exploration and development activities or acquire properties containing proved reserves, or both. Further, the majority of our reserves are proved developed producing. Accordingly, we do not have significant opportunities to increase our production from our existing proved reserves. Our ability to make the necessary capital investment to maintain or expand our asset base of natural gas and oil reserves would be impaired to the extent cash flow from operations is reduced and external sources of capital become limited or unavailable. We may not be successful in exploring for, developing or acquiring additional reserves. If we are not successful, our future production and revenues will be adversely affected.

***Reserve estimates depend on many assumptions that may turn out to be inaccurate. Any material inaccuracies in these reserve estimates or underlying assumptions could materially affect the quantities and present values of our reserves.***

The process of estimating natural gas and oil reserves is complex. It requires interpretations of available technical data and various assumptions, including assumptions relating to economic factors. Any significant inaccuracies in these interpretations or assumptions could materially affect the estimated quantities and present value of reserves shown in this report.

In order to prepare these estimates, our independent third party petroleum engineer must project production rates and timing of development expenditures as well as analyze available geological, geophysical, production and engineering data, and the extent, quality and reliability of this data can vary. The process also requires economic assumptions relating to matters such as natural gas and oil prices, drilling and operating expenses, capital expenditures, taxes and availability of funds. Therefore, estimates of natural gas and oil reserves are inherently imprecise.

Actual future production, natural gas and oil prices, revenues, taxes, development expenditures, operating expenses and quantities of recoverable natural gas and oil reserves most likely will vary from our estimates. Any significant variance could materially affect the estimated quantities and pre-tax net present value of reserves shown in this report. In addition, estimates of our proved reserves may be adjusted to reflect production history, results of exploration and development, prevailing natural gas and oil prices and other factors, many of which are beyond our control. Some of the producing wells included in our reserve report have produced for a relatively short period of time. Because some of our reserve estimates are not based on a lengthy production history and are calculated using volumetric analysis, these estimates are less reliable than estimates based on a more lengthy production history.

You should not assume that the pre-tax net present value of our proved reserves prepared in accordance with SEC guidelines referred to in this report is the current market value of our estimated natural gas and oil reserves. We base the pre-tax net present value of future net cash flows from our proved reserves on prices and costs on the date of the estimate. Actual future prices, costs, taxes and the volume of produced reserves may differ materially from those used in the pre-tax net present value estimate.

## **Table of Contents**

*We rely on the accuracy of the estimates in the reservoir engineering reports provided to us by our outside engineers.*

We have no in house reservoir engineering capability, and therefore rely on the accuracy of the periodic reservoir reports provided to us by our independent third party reservoir engineers. If those reports prove to be inaccurate, our financial reports could have material misstatements. Further, we use the reports of our independent reservoir engineers in our financial planning. If the reports of the outside reservoir engineers prove to be inaccurate, we may make misjudgments in our financial planning.

*Exploration is a high risk activity, and our participation in drilling activities may not be successful.*

Our future success will largely depend on the success of our exploration drilling program. Participation in exploration drilling activities involves numerous risks, including the risk that no commercially productive natural gas or oil reservoirs will be discovered. The cost of drilling, completing and operating wells is often uncertain, and drilling operations may be curtailed, delayed or canceled as a result of a variety of factors, including:

Unexpected drilling conditions.

Blowouts, fires or explosions with resultant injury, death or environmental damage.

Pressure or irregularities in formations.

Equipment failures or accidents.

Tropical storms, hurricanes and other adverse weather conditions.

Compliance with governmental requirements and laws, present and future.

Shortages or delays in the availability of drilling rigs and the delivery of equipment.

Even when properly used and interpreted, 3-D seismic data and visualization techniques are only tools used to assist geoscientists in identifying subsurface structures and hydrocarbon indicators. They do not allow the interpreter to know conclusively if hydrocarbons are present or economically producible. Poor results from our drilling activities would materially and adversely affect our future cash flows and results of operations.

In addition, as a successful efforts company, we choose to account for unsuccessful exploration efforts (the drilling of dry holes) and seismic costs as a current expense of operations, which immediately impacts our earnings. Significant expensed exploration charges in any period would materially adversely affect our earnings for that period and cause our earnings to be volatile from period to period.

*The natural gas and oil business involves many operating risks that can cause substantial losses.*

The natural gas and oil business involves a variety of operating risks, including:

Blowouts, fires and explosions.

Surface cratering.

Uncontrollable flows of underground natural gas, oil or formation water.

Natural disasters.

Pipe and cement failures.

Casing collapses.

Stuck drilling and service tools.

Abnormal pressure formations.

Environmental hazards such as natural gas leaks, oil spills, pipeline ruptures or discharges of toxic gases. If any of these events occur, we could incur substantial losses as a result of:

Injury or loss of life.

Severe damage to and destruction of property, natural resources or equipment.

Pollution and other environmental damage.

Clean-up responsibilities.

Regulatory investigations and penalties.

Suspension of our operations or repairs necessary to resume operations.

## **Table of Contents**

Offshore operations are subject to a variety of operating risks peculiar to the marine environment, such as capsizing and collisions. In addition, offshore operations, and in some instances, operations along the Gulf Coast, are subject to damage or loss from hurricanes or other adverse weather conditions. These conditions can cause substantial damage to facilities and interrupt production. As a result, we could incur substantial liabilities that could reduce the funds available for exploration, development or leasehold acquisitions, or result in loss of properties.

If we were to experience any of these problems, it could affect well bores, platforms, gathering systems and processing facilities, any one of which could adversely affect our ability to conduct operations. In accordance with customary industry practices, we maintain insurance against some, but not all, of these risks. Losses could occur for uninsurable or uninsured risks or in amounts in excess of existing insurance coverage. We may not be able to maintain adequate insurance in the future at rates we consider reasonable, and particular types of coverage may not be available. An event that is not fully covered by insurance could have a material adverse effect on our financial position and results of operations.

### ***Not hedging our production may result in losses.***

Due to the significant volatility in natural gas prices and the potential risk of significant hedging losses if our production should be shut-in during a period when NYMEX natural gas prices increase, our policy is to hedge only through the purchase of puts. By not hedging our production, we may be more adversely affected by declines in natural gas and oil prices than our competitors who engage in hedging arrangements.

### ***Our ability to market our natural gas and oil may be impaired by capacity constraints on the gathering systems and pipelines that transport our natural gas and oil.***

All of our natural gas and oil is transported through gathering systems and pipelines, which we do not own. Transportation capacity on gathering systems and pipelines is occasionally limited and at times unavailable due to repairs or improvements being made to these facilities or due to capacity being utilized by other natural gas or oil shippers that may have priority transportation agreements. If the gathering systems or our transportation capacity is materially restricted or is unavailable in the future, our ability to market our natural gas or oil could be impaired and cash flow from the affected properties could be reduced, which could have a material adverse effect on our financial condition and results of operations.

### ***We have no assurance of title to our leased interests.***

Our practice in acquiring exploration leases or undivided interests in natural gas and oil leases is to not incur the expense of retaining title lawyers to examine the title to the mineral interest prior to executing the lease. Instead, we rely upon the judgment of our alliance partners to perform the field work in examining records in the appropriate governmental, county or parish clerk's office before leasing a specific mineral interest. This practice is widely followed in the industry. Prior to the drilling of an exploration well the operator of the well will typically obtain a preliminary title review of the drillsite lease and/or spacing unit within which the proposed well is to be drilled to identify any obvious deficiencies in title to the well and, if there are deficiencies, to identify measures necessary to cure those defects to the extent reasonably possible. We have no assurance, however, that any such deficiencies have been cured by the operator of any such wells. It does happen, from time to time, that the examination made by title lawyers reveals that the lease or leases are invalid, having been purchased in error from a person who is not the rightful owner of the mineral interest desired. In these circumstances, we may not be able to proceed with our exploration and development of the lease site or may incur costs to remedy a defect. It may also happen, from time to time, that the operator may elect to proceed with a well despite defects to the title identified in the preliminary title opinion.

## **Table of Contents**

***Competition in the natural gas and oil industry is intense, and we are smaller and have a more limited operating history than most of our competitors.***

We compete with a broad range of natural gas and oil companies in our exploration and property acquisition activities. We also compete for the equipment and labor required to operate and to develop these properties. Most of our competitors have substantially greater financial resources than we do. These competitors may be able to pay more for exploratory prospects and productive natural gas and oil properties. Further, they may be able to evaluate, bid for and purchase a greater number of properties and prospects than we can. Our ability to explore for natural gas and oil and to acquire additional properties in the future will depend on our ability to evaluate and select suitable properties and to consummate transactions in this highly competitive environment. In addition, most of our competitors have been operating for a much longer time than we have and have substantially larger staffs. We may not be able to compete effectively with these companies or in such a highly competitive environment.

***We are subject to complex laws and regulations, including environmental regulations that can adversely affect the cost, manner or feasibility of doing business.***

Our operations are subject to numerous laws and regulations governing the operation and maintenance of our facilities and the discharge of materials into the environment. Failure to comply with such rules and regulations could result in substantial penalties and have an adverse effect on us. These laws and regulations may:

Require that we obtain permits before commencing drilling.

Restrict the substances that can be released into the environment in connection with drilling and production activities.

Limit or prohibit drilling activities on protected areas, such as wetlands or wilderness areas.

Require remedial measures to mitigate pollution from former operations, such as plugging abandoned wells.

Under these laws and regulations, we could be liable for personal injury and clean-up costs and other environmental and property damages, as well as administrative, civil and criminal penalties. We maintain only limited insurance coverage for sudden and accidental environmental damages. Accordingly, we may be subject to liability, or we may be required to cease production from properties in the event of environmental damages. These laws and regulations have been changed frequently in the past. In general, these changes have imposed more stringent requirements that increase operating costs or require capital expenditures in order to remain in compliance. It is also possible that unanticipated factual developments could cause us to make environmental expenditures that are significantly different from those we currently expect. Existing laws and regulations could be changed and any such changes could have an adverse effect on our business and results of operations.

***We cannot control the activities on properties we do not operate.***

Other companies currently operate properties in which we have an interest. As a result, we have a limited ability to exercise influence over operations for these properties or their associated costs. Our dependence on the operator and other working interest owners for these projects and our limited ability to influence operations and associated costs could materially adversely affect the realization of our targeted returns on capital in drilling or acquisition activities. The success and timing of our drilling and development activities on properties operated by others therefore depend upon a number of factors that are outside of our control, including:

Timing and amount of capital expenditures.

The operator's expertise and financial resources.

Approval of other participants in drilling wells.

Selection of technology.



## **Table of Contents**

*Acquisition prospects are difficult to assess and may pose additional risks to our operations.*

We expect to evaluate and, where appropriate, pursue acquisition opportunities on terms our management considers favorable. In particular, we expect to pursue acquisitions that have the potential to increase our domestic natural gas and oil reserves. The successful acquisition of natural gas and oil properties requires an assessment of:

Recoverable reserves.

Exploration potential.

Future natural gas and oil prices.

Operating costs.

Potential environmental and other liabilities and other factors.

Permitting and other environmental authorizations required for our operations.

In connection with such an assessment, we would expect to perform a review of the subject properties that we believe to be generally consistent with industry practices. Nonetheless, the resulting conclusions are necessarily inexact and their accuracy inherently uncertain, and such an assessment may not reveal all existing or potential problems, nor will it necessarily permit a buyer to become sufficiently familiar with the properties to fully assess their merits and deficiencies. Inspections may not always be performed on every platform or well, and structural and environmental problems are not necessarily observable even when an inspection is undertaken.

Future acquisitions could pose additional risks to our operations and financial results, including:

Problems integrating the purchased operations, personnel or technologies.

Unanticipated costs.

Diversion of resources and management attention from our exploration business.

Entry into regions or markets in which we have limited or no prior experience.

Potential loss of key employees, particularly those of the acquired organization.

***Anti-takeover provisions of our certificate of incorporation, bylaws and Delaware law could adversely effect a potential acquisition by third parties that may ultimately be in the financial interests of our stockholders.***

Our certificate of incorporation, bylaws and the Delaware General Corporation Law contain provisions that may discourage unsolicited takeover proposals. These provisions could have the effect of inhibiting fluctuations in the market price of our common stock that could result from actual

## Edgar Filing: CONTANGO OIL & GAS CO - Form 10-Q

or rumored takeover attempts, preventing changes in our management or limiting the price that investors may be willing to pay for shares of common stock. These provisions, among other things, authorize the board of directors to:

Designate the terms of and issue new series of preferred stock.

Limit the personal liability of directors.

Limit the persons who may call special meetings of stockholders.

Prohibit stockholder action by written consent.

Establish advance notice requirements for nominations for election of the board of directors and for proposing matters to be acted on by stockholders at stockholder meetings.

Require us to indemnify directors and officers to the fullest extent permitted by applicable law.

Impose restrictions on business combinations with some interested parties.

***Our common stock is thinly traded.***

Contango has approximately 15 million shares of common stock outstanding, held by approximately 119 holders of record. Directors and officers own or have voting control over approximately 3.5 million shares. Since our common stock is thinly traded, the purchase or sale of relatively small common stock positions may result in disproportionately large increases or decreases in the price of our common stock.

---

**Table of Contents****Item 3. Quantitative and Qualitative Disclosure About Market Risk**

*Interest Rate and Credit Rating Risks.* As of September 30, 2006, we had approximately \$12.7 million in cash and cash equivalents, and short term investments. At September 30, 2006, approximately \$1.6 million was held in our operating accounts to be used for general corporate purposes, and approximately \$2.1 million was invested in highly liquid AAA-rated tax-exempt money market funds. The remaining \$9.0 million was invested in a portfolio of periodic auction reset ( PAR ) securities that have coupons periodically reset to market interest rates. These PAR securities are being classified as short term investments and consist of AAA-rated tax exempt municipal bonds. PAR securities are highly liquid and have minimal interest rate risk.

Our money market funds are highly liquid AAA-rated tax-exempt securities with maturities of 90 days or less. We consider all highly liquid debt instruments having an original maturity of 90 days or less to be cash equivalents.

Investments in fixed-rate, interest-earning instruments carry a degree of interest rate and credit rating risk. Fixed-rate securities may have their fair market value adversely impacted because of changes in interest rates and credit ratings. Additionally, the value of our investments may be impaired temporarily or permanently. Due in part to these factors, our investment income may decline and we may suffer losses in principal. Currently, we do not use any derivative or other financial instruments or derivative commodity instruments to hedge any market risks, including changes in interest rates or credit ratings, and we do not plan to employ these instruments in the future. Because of the nature of the issuers of the securities that we invest in, we do not believe that we have any cash flow exposure arising from changes in credit ratings. Based on a sensitivity analysis performed on the financial instruments held as of September 30, 2006, an immediate 10% change in interest rates is not expected to have a material effect on our near-term financial condition or results of operations.

*Commodity Risk.* Our major commodity price risk exposure is to the prices received for our natural gas and oil production. Realized commodity prices received for our production are the spot prices applicable to natural gas and crude oil. Prices received for natural gas and oil are volatile and unpredictable and are beyond our control. For the quarter ended September 30, 2006, a 10% fluctuation in the prices received for natural gas and oil production would not have a material impact on our revenues.

*Hedging Activities.* Due to the significant volatility in natural gas and crude oil prices and the potential risk of significant hedging losses if NYMEX natural gas prices spike on the date options settle, our policy is to hedge only through the purchase of puts. During the three month period ended September 30, 2006, we had no commodity hedge activity.

**Item 4. Controls and Procedures**

Kenneth R. Peak, our Chief Executive Officer and Chief Financial Officer, carried out an evaluation of the effectiveness of the Company's disclosure controls and procedures as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act ), as of September 30, 2006. Based upon that evaluation, Mr. Peak concluded that, as of September 30, 2006, the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and to ensure that the information required to be disclosed by us in reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in the Company's internal control over financial reporting that occurred during the fiscal quarter ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents****PART II - OTHER INFORMATION****Item 1A. Risk Factors**

The description of the risk factors associated with the Company set forth under the heading "Risk Factors" in Item 2 of Part I, "Management's Discussion and Analysis of Financial Condition and Results of Operations," of this Form 10-Q are incorporated into this Item 1A by reference and supersede the description of risk factors set forth under the heading "Risk Factors" in Item 1 of Part I of our annual report on Form 10-K.

**Item 6. Exhibits****(a) Exhibits:**

The following is a list of exhibits filed as part of this Form 10-Q. Where so indicated by a footnote, exhibits, which were previously filed, are incorporated herein by reference.

**Exhibit**

<b>Number</b>	<b>Description</b>
2.1	Purchase and Sale Agreement, by and between Juneau Exploration, L.P. and REX Offshore Corporation, dated as of September 1, 2005. (1)
2.2	Purchase and Sale Agreement, by and between Juneau Exploration, L.P. and COE Offshore, LLC dated as of September 1, 2005. (1)
2.3	Purchase and Sale Agreement between Contango STEP, LP and Rosetta Resources Operating LP, dated April 28, 2006 (7)
3.1	Certificate of Incorporation of Contango Oil & Gas Company. (2)
3.2	Bylaws of Contango Oil & Gas Company. (2)
3.3	Agreement of Plan of Merger of Contango Oil & Gas Company, a Delaware corporation, and Contango Oil & Gas Company, a Nevada corporation. (2)
3.4	Amendment to the Certificate of Incorporation of Contango Oil & Gas Company. (3)
4.1	Facsimile of common stock certificate of Contango Oil & Gas Company. (4)
4.2	Certificate of Designations, Preferences and Relative Rights and Limitations for Series C Senior Convertible Cumulative Preferred Stock of Contango Oil & Gas Company. (5)
4.3	Certificate of Designations, Preferences and Relative Rights and Limitations for Series D Perpetual Cumulative Convertible Preferred Stock of Contango Oil & Gas Company. (6)
4.4	Securities Purchase Agreement, dated as of July 15, 2005, among Contango Oil & Gas Company and the Purchasers Named Therein. (6)
10.1	Term Loan Agreement between Contango Oil & Gas Company and The Royal Bank of Scotland plc, dated April 27, 2006. (7)
10.2	Demand Promissory Note dated October 26, 2006 with Schedules I, II and III.
23.1	Consent of W.D. Von Gonten & Co.
23.2	Consent of William M. Cobb & Associates, Inc.
31.1	Certification required by Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934.
32.1	Certification pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Filed herewith.

1. Filed as an exhibit to the Company's report on Form 8-K, dated September 2, 2005, as filed with the Securities and Exchange Commission on September 8, 2005.
2. Filed as an exhibit to the Company's report on Form 8-K, dated December 1, 2000, as filed with the Securities and Exchange Commission on December 15, 2000.
3. Filed as an exhibit to the Company's report on Form 10-QSB for the quarter ended December 31, 2002, dated November 14, 2002, as filed with the Securities and Exchange Commission.
4. Filed as an exhibit to the Company's Form 10-SB Registration Statement, as filed with the Securities and Exchange Commission on October 16, 1998.
5. Filed as an exhibit to the Company's report on Form 8-K, dated December 12, 2003, as filed with the Securities and Exchange Commission on December 17, 2003.
- 6.

## Edgar Filing: CONTANGO OIL & GAS CO - Form 10-Q

Filed as an exhibit to the Company's Registration Statement filed on Form S-3 as filed with the Securities and Exchange Commission on August 2, 2005.

7. Filed as an exhibit to the Company's report on Form 10-Q for the quarter ended March 31, 2006, dated May 15, 2006, as filed with the Securities and Exchange Commission.

**Table of Contents**

**8. SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereto duly authorized.

**CONTANGO OIL & GAS COMPANY**

Date: November 8, 2006

By: /s/ KENNETH R. PEAK  
Kenneth R. Peak  
Chairman, Chief Executive Officer and  
Chief Financial Officer  
(Principal Executive and Financial Officer)

Date: November 8, 2006

By: /s/ LESIA BAUTINA  
Lesia Bautina  
Senior Vice President and Controller  
(Principal Accounting Officer)