

CALLON PETROLEUM CO
Form 10-Q
May 08, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM
10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For The Quarterly Period Ended March 31, 2014

OR

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF SECURITIES EXCHANGE ACT OF 1934

Commission File Number 001-14039

Callon Petroleum Company

(Exact Name of Registrant as Specified in Its Charter)

Delaware 64-0844345

(State or Other (IRS
Jurisdiction of Employer

Edgar Filing: CALLON PETROLEUM CO - Form 10-Q

Incorporation Identification
or No.)
Organization)

200 North
Canal Street

Natchez,
Mississippi

(Address of
Principal 39120
Executive
Offices) (Zip Code)

601-442-1601

(Registrant's Telephone Number, Including Area Code)

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

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

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

As of May 2, 2014, 40,449,884 shares of the Registrant's common stock, par value \$0.01 per share, were outstanding.

Table of Contents

Part I. Financial Information

Item 1. Financial Statements (Unaudited)

<u>Consolidated Balance Sheets</u>	4
------------------------------------	---

<u>Consolidated Statements of Operations</u>	5
--	---

<u>Consolidated Statements of Cash Flows</u>	6
--	---

<u>Notes to Consolidated Financial Statements</u>	7
---	---

<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
--	----

<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	24
---	----

<u>Item 4. Controls and Procedures</u>	25
--	----

Part II. Other Information

<u>Item 1. Legal Proceedings</u>	26
----------------------------------	----

<u>Item 1A. Risk Factors</u>	26
------------------------------	----

<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	26
--	----

<u>Item 3. Defaults Upon Senior Securities</u>	26
--	----

<u>Item 4. Mine Safety Disclosures</u>	26
--	----

<u>Item 5. Other Information</u>	26
----------------------------------	----

<u>Item 6. Exhibits</u>	27
-------------------------	----

Table of Contents

DEFINITIONS

All defined terms under Rule 4-10(a) of Regulation S-X shall have their statutorily prescribed meanings when used in this report. As used in this document:

- ARO: Asset Retirement Obligation.
- Bbl or Bbls: barrel or barrels of oil or natural gas liquids.
- Bcf: billion cubic feet.
- BOE: barrel of oil equivalent, determined by using the ratio of one Bbl of oil or NGLs to six Mcf of gas. The ratio of one barrel of oil or NGL to six Mcf of natural gas is commonly used in the industry and represents the approximate energy equivalence of oil or NGLs to natural gas, and does not represent the economic equivalency of oil and NGLs to natural gas. The sales price of a barrel of oil or NGLs is considerably higher than the sales price of six Mcf of natural gas.
- BOE/d: BOE per day.
- Btu: a British thermal unit, which is a measure of the amount of energy required to raise the temperature of one pound of water one degree Fahrenheit.
- LIBOR: London Interbank Offered Rate.
- LOE: lease operating expense.
- MBbls: thousand barrels of oil.
- MBOE: thousand boe.
- MBOE/d: Mboe per day.
- Mcf: thousand cubic feet of natural gas.
- Mcfe: thousand cubic feet of natural gas equivalents.
- Mcf/d: Mcf per day.
- MMBbls: million barrels of oil.
- MMBOE: million BOE.
- MMBtu: million Btu.
- MMcf: million cubic feet of natural gas.
- MMcf/d: MMcf per day.
- NGL or NGLs: natural gas liquids, such as ethane, propane, butanes and natural gasoline that are extracted from natural gas production streams.
- NYMEX: New York Mercantile Exchange.
- Oil: includes crude oil and condensate.
- SEC: United States Securities and Exchange Commission.
- GAAP: Generally Accepted Accounting Principles in the United States

With respect to information relating to our working interest in wells or acreage, “net” oil and gas wells or acreage is determined by multiplying gross wells or acreage by our working interest therein. Unless otherwise specified, all references to wells and acres are gross.

Table of Contents

Part I. Financial Information

Item I. Financial Statements

Callon Petroleum Company

Consolidated Balance Sheets

(in thousands, except par and per share values and share data)

	March 31, 2014 Unaudited	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 1,742	\$ 3,012
Accounts receivable	23,237	20,586
Fair market value of derivatives	—	60
Deferred tax asset, current	6,320	3,843
Other current assets	1,356	2,063
Total current assets	32,655	29,564
Oil and natural gas properties, full-cost accounting method:		
Evaluated properties	1,783,598	1,701,577
Less accumulated depreciation, depletion and amortization	(1,432,213)	(1,420,612)
Net oil and natural gas properties	351,385	280,965
Unevaluated properties excluded from amortization	36,772	43,222
Total oil and natural gas properties	388,157	324,187
Other property and equipment, net	7,413	7,255
Restricted investments	3,806	3,806
Deferred tax asset	54,047	57,765
Other assets, net	3,168	1,376
Total assets	\$ 489,246	\$ 423,953
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 71,293	\$ 57,637
Asset retirement obligations	4,483	4,120
Fair market value of derivatives	2,645	1,036
Total current liabilities	78,421	62,793
13% Senior Notes:		
Principal outstanding	48,481	48,481
Deferred credit, net of accumulated amortization of \$26,673 and \$26,239, respectively	4,834	5,267
Total 13% Senior Notes	53,315	53,748
Senior secured revolving credit facility	68,000	22,000
Asset retirement obligations	2,767	2,612
Other long-term liabilities	6,163	3,706
Total liabilities	208,666	144,859
Stockholders' equity:	16	16

Edgar Filing: CALLON PETROLEUM CO - Form 10-Q

Preferred stock, series A cumulative, \$0.01 par value and \$50.00 liquidation preference, 2,500,000 shares authorized: 1,578,948 and 1,578,948 shares outstanding, respectively		
Common stock, \$0.01 par value, 110,000,000 and 60,000,000 shares authorized; 40,365,710 and 40,345,456 shares outstanding, respectively	405	404
Capital in excess of par value	403,136	401,540
Accumulated deficit	(122,977)	(122,866)
Total stockholders' equity	280,580	279,094
Total liabilities and stockholders' equity	\$ 489,246	\$ 423,953

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

Table of Contents

Callon Petroleum Company

Consolidated Statements of Operations

(Unaudited; in thousands, except per share data)

	Three Months Ended March 31,	
	2014	2013
Operating revenues:		
Oil sales	\$ 30,909	\$ 19,540
Natural gas sales	2,376	3,001
Total operating revenues	33,285	22,541
Operating expenses:		
Lease operating expenses	4,230	5,576
Production taxes	1,917	721
Depreciation, depletion and amortization	10,538	11,042
General and administrative	10,807	3,739
Accretion expense	228	565
Gain on sale of other property and equipment	(1,080)	—
Total operating expenses	26,640	21,643
Income from operations	6,645	898
Other (income) expenses:		
Interest expense	977	1,515
Loss on derivative contracts	2,513	418
Other (income) expense	(49)	(45)
Total other expenses	3,441	1,888
Income (loss) before income taxes	3,204	(990)
Income tax expense (benefit)	1,341	(169)
Income (loss) before equity in earnings of Medusa Spar LLC	1,863	(821)
Equity in earnings of Medusa Spar LLC	—	21
Net income (loss)	1,863	(800)
Preferred stock dividends	(1,974)	—
Loss available to common stockholders	\$ (111)	\$ (800)
Loss per common share:		
Basic	\$ (0.00)	\$ (0.02)
Diluted	\$ (0.00)	\$ (0.02)
Shares used in computing loss per common share:		
Basic	40,328	39,793
Diluted	40,328	39,793

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

Table of Contents

Callon Petroleum Company

Consolidated Statements of Cash Flows

(Unaudited; in thousands)

	Three Months Ended March 31	
	2014	2013
Cash flows from operating activities:		
Net income	\$ 1,863	\$ (800)
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation, depletion and amortization	10,598	11,393
Accretion expense	228	565
Amortization of non-cash debt related items	119	111
Amortization of deferred credit	(433)	(799)
Equity in earnings of Medusa Spar LLC	—	(21)
Deferred income tax expense	1,341	(169)
Net loss (gain) on derivatives, net of settlements	1,639	1,039
Gain on sale of other property and equipment	(1,080)	—
Non-cash expense related to equity share-based awards	996	580
Change in the fair value of liability share-based awards	3,483	(195)
Payments to settle asset retirement obligations	(26)	(396)
Changes in current assets and liabilities:		
Accounts receivable	(2,928)	1,333
Other current assets	707	857
Current liabilities	5,155	158
Payments to settle vested liability share-based awards	(1,669)	—
Change in other long-term liabilities	—	(206)
Change in other assets, net	(26)	(575)
Net cash provided by operating activities	19,967	12,875
Cash flows from investing activities:		
Capital expenditures	(65,760)	(30,089)
Proceeds from sales of mineral interest and equipment	2,226	114
Distribution from Medusa Spar LLC	—	340
Net cash used in investing activities	(63,534)	(29,635)
Cash flows from financing activities:		
Borrowings on credit facility	46,000	17,000
Payment of deferred financing costs	(1,729)	—
Payment of preferred stock dividends	(1,974)	—
Net cash provided by financing activities	42,297	17,000
Net change in cash and cash equivalents	(1,270)	240
Balance, beginning of period	3,012	1,139
Balance, end of period	\$ 1,742	\$ 1,379

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

Table of Contents

Callon Petroleum Company

Notes to the Consolidated Financial Statements

(Unless otherwise indicated, dollar amounts included in the footnotes to the financial statements are presented in thousands, except for per share and per unit data)

INDEX TO THE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

<u>1.</u> Description of Business and Basis of Presentation	<u>6.</u> Fair Value Measurements
<u>2.</u> Oil and Natural Gas Properties	<u>7.</u> Income Taxes
<u>3.</u> Earnings Per Share	<u>8.</u> Asset Retirement Obligations
<u>4.</u> Borrowings	<u>9.</u> Preferred Stock
<u>5.</u> Derivative Instruments and Hedging Activities	<u>10.</u> Other

Note 1 - Description of Business and Basis of Presentation

Description of business

Callon Petroleum Company is an independent oil and natural gas company established in 1950. The Company was incorporated under the laws of the state of Delaware in 1994 and succeeded to the business of a publicly traded limited partnership, a joint venture with a consortium of European investors and an independent energy company partially owned by a member of current management. As used herein, the “Company,” “Callon,” “we,” “us,” and “our” refer to Callon Petroleum Company and its predecessors and subsidiaries unless the context requires otherwise.

Callon is focused on the acquisition, development, exploration and exploitation of unconventional oil and natural gas reserves in the Permian Basin in West Texas. In late 2013, with the sale of its remaining offshore assets in the Gulf of Mexico, the Company completed the onshore strategic repositioning it initiated in 2009.

Basis of presentation

Unless otherwise indicated, all dollar amounts included within the footnotes to the financial statements are presented in thousands, except for per share and per unit data.

The interim consolidated financial statements of the Company have been prepared in accordance with (1) accounting principles generally accepted in the United States ("US GAAP"), (2) the Securities and Exchange Commission's instructions to Quarterly Report on Form 10-Q and (3) Rule 10-01 of Regulation S-X, and include the accounts of the Company, and its subsidiary, Callon Petroleum Operating Company ("CPOC"). CPOC also has subsidiaries, namely Callon Offshore Production, Inc., and Mississippi Marketing, Inc.

These interim consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2013. The balance sheet at December 31, 2013 has been derived from the audited financial statements at that date.

Operating results for the periods presented are not necessarily indicative of the results that may be expected for the year ended December 31, 2014.

In the opinion of management, the accompanying unaudited consolidated financial statements reflect all adjustments, including normal recurring adjustments and all intercompany account and transaction eliminations, necessary to present fairly the Company's financial position, the results of its operations and its cash flows for the periods indicated. When necessary to ensure consistent presentation, certain prior year amounts may be reclassified. Certain prior year amounts have been reclassified to conform to current year presentation.

Footnotes to the Financial Statements (continued)

Table of
Contents

(Unless otherwise indicated, dollar amounts included in the footnotes to the financial statements are presented in thousands, except for per share and per unit data)

Note 2 – Oil and Natural Gas Properties

Acquisitions

In the first quarter of 2014, the Company acquired 1,527 net acres in Upton and Reagan Counties, Texas, which are located in the southern portion of the Midland Basin near our existing core development fields, for an aggregate cash purchase price of \$8,200. The properties bear a working interest of 100% and an average net revenue interest of 78%.

Acreage Expiration

During the first quarter of 2014, the Company transferred \$9,855 from unevaluated properties to the full cost pool related to 5,924 net acres in the Northern Midland Basin that expired or are scheduled to expire in the near future and are no longer included in the Company's exploration and development plans. The Company continues to narrow its focus acreage for continued exploration and delineation efforts, which remains focused on horizontal development drilling in the Southern and Central portions of the Midland Basin. As of March 31, 2014, Callon has a remaining net acreage position in the Northern Midland Basin of 11,857 acres for which the Company is still evaluating potential future exploration activities.

Note 3 - Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share:

(share amounts in thousands)	Three Months Ended March 31,
------------------------------	---------------------------------

Edgar Filing: CALLON PETROLEUM CO - Form 10-Q

	2014	2013
Net income (loss)	\$ 1,863	\$ (800)
Preferred stock dividends	(1,974)	—
Loss available to common stockholders	\$ (111)	\$ (800)
Weighted average shares outstanding	40,328	39,793
Weighted average shares outstanding for diluted net loss per share	40,328	39,793
Basic loss per share	\$ (0.00)	\$ (0.02)
Diluted loss per share	\$ (0.00)	\$ (0.02)

The following were excluded from the diluted earnings per share calculation because their effect would be anti-dilutive:

Stock options	40	67
Restricted stock	—	40

Note 4 – Borrowings

The Company's borrowings consisted of the following at:

	March 31, 2014	December 31, 2013
Principal components:		
Credit Facility	\$ 68,000	\$ 22,000
13% Senior Notes, principal	48,481	48,481
Total principal outstanding	116,481	70,481
13% Senior Notes unamortized deferred credit	4,834	5,267
Total carrying value of borrowings	\$ 121,315	\$ 75,748

Senior Secured Revolving Credit Facility (the "Credit Facility")

On March 11, 2014, the Company entered into the Fifth Amended and Restated Credit Agreement to the Credit Facility. The total amount available under the Credit Facility is \$500,000, with an initial associated borrowing base of \$95,000 and a maturity of March 11, 2019. JPMorgan Chase Bank, N.A. is Administrative Agent, and participating lenders include Regions Bank, Citibank, N.A., Capital One, N.A., KeyBank, N.A., Whitney Bank, IberiaBank, N.A., OneWest Bank, N.A., SunTrust Bank and Royal Bank of Canada. Amounts borrowed under the Credit Facility may not exceed the borrowing base, which is

Footnotes to the Financial Statements (continued)

Table of
Contents

(Unless otherwise indicated, dollar amounts included in the footnotes to the financial statements are presented in thousands, except for per share and per unit data)

generally reviewed on a semi-annual basis. The first redetermination is scheduled with an effective date of May 30, 2014, with subsequent redeterminations occurring every six months beginning on September 1, 2014. The Credit Facility is secured by first preferred mortgages covering the Company's major producing properties.

As of March 31, 2014, the balance outstanding on the Credit Facility was \$68,000 with a weighted interest rate of 2.41%, calculated as the London Interbank Offered Rate ("LIBOR") plus a tiered rate ranging from 1.75% to 2.75%, which is determined based on utilization of the facility. In addition, the Credit Facility carries a commitment fee of 0.5% per annum, payable quarterly, on the unused portion of the borrowing base.

Second Lien Term Loan Facility (the "Second Lien Facility")

The Company also entered into the Second Lien Facility in an aggregate amount of up to \$125,000, including initial commitments of \$100,000 and additional availability of \$25,000 subject to the consent of two-thirds of the lenders and compliance with financial covenants after giving effect to such increase. The Second Lien Facility, matures on September 11, 2019, and is not subject to mandatory prepayments unless new debt is issued. The Second Lien Facility may be prepaid at our option if we pay a prepayment premium. The prepayment premium is (i) 102% if the prepayment event occurs prior to March 11, 2015, and (ii) 101% if the prepayment event occurs on or after March 15, 2015 but before March 15, 2016, and (iii) 100% for prepayments made on or after March 15, 2016. The Second Lien Facility is secured by junior liens on properties mortgaged under the Credit Facility, subject to an intercreditor agreement.

There were no outstanding balances on the Second Lien Facility as of March 31, 2014. The initial draw amount of \$62,500 was made on April 10, 2014 with an original issue discount of 1.0%. Subsequent draws, allowable during the first year, are subject to the same 1.0% original issue discount on the drawn amount, applied on the date such draw is funded. Beginning on April 10, 2014, the interest rate is 8.75%, calculated at a rate of LIBOR (subject to a floor rate of 1.0%) plus 7.75% per annum. In addition, the Second Lien Facility carries a commitment fee of 0.5% per annum, payable quarterly, on the unused portion of the initial commitment amount until March 11, 2015.

13% Senior Notes due 2016 ("Senior Notes") and Deferred Credit

On April 11, 2014, the Company completed a full redemption of the remaining \$48,481 principal amount of outstanding Senior Notes using proceeds from the Second Lien Facility. The redemption, which will be accounted for in the quarter ending June 30, 2014, will result in a net \$3,204 gain on the early extinguishment of debt (including \$4,780 of accelerated deferred credit amortization). The gain represents the difference between the \$50,047 paid for the redemption of the Senior Notes (\$1,576 of redemption costs, primarily the call premium) and the carrying value of the remaining Senior Notes of \$53,261 (inclusive of \$4,780 of deferred credit). The Company also paid \$193 for accrued interest through the redemption date. Upon the redemption, the indenture governing the Senior Notes was discharged in accordance with its terms.

Interest on the Senior Notes was payable on the last day of each quarter. Certain of the Company's subsidiaries guaranteed the Company's obligations under the Senior Notes. The subsidiary guarantors were 100% owned, all of the guarantees were full and unconditional and joint and several, the parent company had no independent assets or operations, and any subsidiaries of the parent company other than the subsidiary guarantors were minor. Upon issuing the Senior Notes in November 2009, the Company recorded as a deferred credit the \$31,507 difference between the adjusted carrying amount of the previous Senior Notes that were exchanged and the principal of the new Senior Notes. This deferred credit was being amortized as a reduction of interest expense over the life of the Senior Notes at an 8.5% effective interest rate.

As of March 31, 2014, the deferred credit balance was \$4,834, net of \$26,673 of amortization through that date. Amortization recorded as a reduction of interest expense for the quarter ended March 31, 2014 was \$433.

Restrictive Covenants

The indentures governing the Senior Notes, Credit Facility and Second Lien Facility contain various covenants including restrictions on additional indebtedness and payment of cash dividends. In addition, the Credit Facility and Second Lien Facility contain covenants for maintenance of certain financial ratios. The Company was in compliance with these covenants at March 31, 2014.

Footnotes to the Financial Statements (continued)

[Table of Contents](#)

(Unless otherwise indicated, dollar amounts included in the footnotes to the financial statements are presented in thousands, except for per share and per unit data)

Note 5 - Derivative Instruments and Hedging Activities

Objectives and strategies for using derivative instruments

The Company is exposed to fluctuations in oil and natural gas prices received for its production. Consequently, the Company believes it is prudent to manage the variability in cash flows on a portion of its oil and natural gas production. The Company utilizes a mix of collar, swap, put, call and similar derivative financial instruments to manage fluctuations in cash flows resulting from changes in commodity prices. The Company does not use these instruments for speculative or trading purposes.

Counterparty risk and offsetting

The use of derivative transactions exposes the Company to the risk that a counterparty will be unable to meet its commitments. While the Company monitors counterparty creditworthiness on an ongoing basis, it cannot predict sudden changes in counterparties' creditworthiness. In addition, even if such changes are not sudden, the Company may be limited in its ability to mitigate an increase in counterparty credit risk. Should one of these counterparties not perform, the Company may not realize the benefit of some of its derivative instruments under lower commodity prices while continuing to be obligated under higher commodity price contracts subject to any right of offset under the agreements. Counterparty credit risk is considered when determining a derivative instruments' fair value; see Note 6 for additional information regarding fair value.

The Company executes commodity derivative transactions under master agreements that have netting provisions that provide for offsetting payables against receivables. In general, if a party to a derivative transaction incurs an event of default, as defined in the applicable agreement, the other party will have the right to demand the posting of collateral, demand a cash payment transfer or terminate the arrangement.

Financial statement presentation and settlements

Settlements of the Company's derivative instruments are based on the difference between the contract price or prices specified in the derivative instrument and a benchmark price, such as the New York Mercantile Exchange ("NYMEX") price. To determine the fair value of the Company's derivative instruments, depending on the type of instrument, the Company utilizes present value methods or standard option valuation models that include assumptions about commodity prices based on those observed in underlying markets. See Note 6 for additional information regarding fair value.

Derivatives not designated as hedging instruments

The Company has elected not to designate its derivative contracts as accounting hedges under Accounting Standards Codification 815. Consequently, the Company records its derivative contracts at their fair values on the balance sheet and marks-to-market these contracts at the end of each period. The Company records changes in fair values as a gain or loss on the statement of operations as a component of gain (loss) on derivative contracts. The gain (loss) on derivative contracts in the statement of operations includes the mark-to-market adjustments on outstanding contracts and the impact of cash settlements.

The following table reflects the fair values of the Company's derivative instruments for the periods presented:

Commodity	Balance Sheet Presentation		Asset Fair Value		Liability Fair Value		Net Derivative Fair Value	
	Classification	Line Description	03/31/2014	12/31/2013	03/31/2014	12/31/2013	03/31/2014	12/31/2013
Natural gas	Current	Fair market value of derivatives	\$ —	\$ 60	\$ (160)	\$ —	\$ (160)	\$ 60
Natural gas	Non-current	Other long-term liabilities	—	—	(41)	(72)	(41)	(72)
Oil	Current	Fair market value of derivatives	—	—	(2,485)	(1,036)	(2,485)	(1,036)
	Totals		\$ —	\$ 60	\$ (2,686)	\$ (1,108)	\$ (2,686)	\$ (1,048)

Footnotes to the Financial Statements (continued)

[Table of
Contents](#)

(Unless otherwise indicated, dollar amounts included in the footnotes to the financial statements are presented in thousands, except for per share and per unit data)

As previously discussed, the Company's derivative contracts are subject to master netting arrangements. The Company's policy is to present the fair value of derivative contracts on a net basis based on the underlying commodity being hedged. The following presents the impact of this presentation to the Company's recognized assets and liabilities at March 31, 2014: