

TETON ENERGY CORP  
Form 10-Q  
May 15, 2007

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**U.S. SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D. C. 20549**  
**FORM 10-Q**

(Mark One)

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

**For the Quarterly Period Ended March 31, 2007**

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

**For the transition period from**            **to**

*Commission file number: 001-31679*

**TETON ENERGY CORPORATION**

(Exact name of registrant as specified in its charter)

**DELAWARE**

**84-1482290**

(State or other jurisdiction of  
incorporation or organization)

(IRS Employer  
Identification No.)

**410 17<sup>th</sup> Street Suite 1850**  
**Denver, Colorado**

(Address of principal executive offices)

**80202**

(Zip Code)

**(303) 565-4600**

(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 periods 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 (as defined in Rule 12b-2 of the 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 Act). Yes  No   
As of May 9, 2007, 16,123,047 shares of the issuer's common stock were outstanding.

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**TETON ENERGY CORPORATION AND SUBSIDIARIES**  
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**Table of Contents****Part 1. FINANCIAL INFORMATION****Item 1. Consolidated Financial Statements****TETON ENERGY CORPORATION AND SUBSIDIARIES****Consolidated Balance Sheets**

	<b>March 31, 2007 (Unaudited)</b>	<b>December 31, 2006</b>
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 1,246,325	\$ 4,324,784
Trade accounts receivable	315,736	860,070
Advances to operator		401,491
Tubular inventory	148,628	148,628
Fair value of derivatives	309,981	402,867
Prepaid expenses and other assets	110,491	142,163
Total current assets	2,131,161	6,280,003
Non-current assets		
Oil and gas properties (using successful efforts method of accounting)		
Proved	11,713,723	11,635,699
Producing facilities	2,165,625	690,244
Unproved	13,967,553	13,959,480
Wells in progress	13,646,687	8,492,150
Facilities in progress	1,851,440	1,363,644
Land	300,000	300,000
Fixed assets	247,797	242,691
Total property and equipment	43,892,825	36,683,908
Less accumulated depreciation and depletion	(2,459,155)	(1,911,889)
Net property and equipment	41,433,670	34,772,019
Debt issuance costs - net	194,606	191,685
Total non-current assets	41,628,276	34,963,704
Total assets	\$ 43,759,437	\$ 41,243,707
<b>Liabilities and Stockholders Equity</b>		
Current liabilities		
Accounts payable	\$ 4,178,263	\$ 1,506,873
Accrued liabilities	2,943,727	4,195,674
Accrued payroll and severance	153,863	890,877

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Accrued franchise taxes payable	75,244	30,518
Accrued purchase consideration	463,074	775,054
Total current liabilities	7,814,171	7,398,996
Long term liabilities		
Long term debt	1,000,000	
Asset retirement obligations	197,613	78,115
Other	59,214	
Total long term liabilities	1,256,827	78,115
Commitments		
Stockholders equity		
Common stock, \$0.001 par value, 250,000,000 shares authorized, 16,123,047 and 15,180,649 shares issued and outstanding at March 31, 2007 and December 31, 2006, respectively	16,123	15,180
Additional paid in capital	62,664,650	60,836,839
Stock based compensation	4,032,807	3,138,772
Accumulated deficit	(32,025,141)	(30,224,195)
Total stockholders equity	34,688,439	33,766,596
Total liabilities and stockholders equity	\$ 43,759,437	\$ 41,243,707

See notes to unaudited consolidated financial statements

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**TETON ENERGY CORPORATION AND SUBSIDIARIES**  
**Consolidated Statements of Operations and Comprehensive Loss**  
**(Unaudited)**

	<b>For the Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2007</b>	<b>2006</b>
Oil and gas sales	\$ 1,068,341	\$ 290,249
Cost of sales and expenses:		
Lease operating expense	42,893	33,788
Production taxes	64,000	8,018
General and administrative	1,879,348	1,342,803
Depreciation, depletion and amortization	547,266	95,766
Accretion expense from asset retirement obligations	7,607	
Exploration expense	306,134	140,516
Total cost of sales and expenses	2,847,248	1,620,891
Loss from operations	(1,778,907)	(1,330,642)
Other income (expense):		
Realized gain on derivative contract	54,900	
Unrealized derivative loss	(92,886)	
Interest income	28,981	68,017
Interest expense	(13,034)	
Total other income (expense)	(22,039)	68,017
Net loss applicable to common shares	\$ (1,800,946)	\$ (1,262,625)
Basic and diluted weighted average common shares outstanding	15,599,815	11,622,229
Basic and diluted loss per common share	\$ (0.12)	\$ (0.11)

See notes to unaudited consolidated financial statements.

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**TETON ENERGY CORPORATION AND SUBSIDIARIES**  
**Consolidated Statements of Cash Flows**  
**(Unaudited)**

	<b>For the Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2007</b>	<b>2006</b>
Cash flows from operating activities		
Net loss	\$ (1,800,946)	\$ (1,262,625)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and depletion	547,266	95,766
Debt issuance cost amortization	13,034	
Accretion expense from asset retirement obligations	7,607	
Accrued stock based compensation net of stock returned	894,035	331,523
Unrealized derivative loss	92,886	
Changes in assets and liabilities		
Discontinued operations		(255,000)
Trade accounts receivable	544,334	155,116
Prepaid expenses and other current assets	31,672	90,280
Accounts payable and accrued liabilities	151,181	(11,988)
Accrued payroll and severance and franchise taxes payable	(692,288)	(51,633)
Other liabilities	59,214	
	1,648,941	354,064
Net cash used in operating activities	(152,005)	(908,561)
Cash flows from investing activities		
Proceeds from sale of oil and gas properties		2,700,000
Purchase of fixed assets	(5,106)	
Development of oil and gas properties	(5,734,147)	(2,027,957)
Net cash used in investing activities	(5,739,253)	672,043
Cash flows from financing activities		
Proceeds from exercise of warrants and issuance of stock, net of issue costs of \$0 and \$0, respectively	1,828,754	2,710,892
Borrowings from credit facility	1,000,000	
Debt issuance costs from bank debt	(15,955)	
Net cash provided by financing activities	2,812,799	2,710,892
Net increase (decrease) in cash and cash equivalents	(3,078,459)	2,474,374
Cash and cash equivalents beginning of year	4,324,784	7,064,295
Cash and cash equivalents end of period	\$ 1,246,325	\$ 9,538,669

See notes to unaudited consolidated financial statements.



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**TETON ENERGY CORPORATION AND SUBSIDIARIES**  
**Consolidated Statements of Cash Flows continued**  
**(Unaudited)**

	<b>For the Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2007</b>	<b>2006</b>
Supplemental disclosure of non-cash activity:		
Accrued stock based compensation	\$ 894,035	\$ 489,023
Reduction in accounting service fees		(157,500)
Deposit applied to oil and gas properties Note 1		300,000
Capital expenditures included in accounts payable and accrued liabilities	6,603,208	1,512,265
Asset retirement obligation associated with oil and gas properties	111,891	
Unrealized derivative loss	92,886	

See notes to unaudited consolidated financial statements.

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**Notes to Consolidated Financial Statements  
(Unaudited)**

**Note 1 Organization and Summary of Significant Accounting Policies**

**Organization**

Teton Energy Corporation (the Company, Teton, we, or us ) was formed in November 1996 and is incorporated in the State of Delaware. We are an independent energy company engaged primarily in the development, production, and marketing of natural gas and oil in North America. Our strategy is to increase shareholder value by profitably growing reserves and production, primarily through acquiring under-valued properties with reasonable risk-reward potential and by participating in or actively conducting drilling operations in order to exploit our properties. We seek high-quality exploration and development projects with potential for providing long-term drilling inventories that generate high returns. Our current operations are focused in three basins in the Rocky Mountain region of the United States.

**Interim Reporting**

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance 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 (the SEC ), they do not necessarily include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, the accompanying unaudited consolidated financial statements include all adjustments (consisting of normal and recurring accruals) considered necessary to present fairly our financial position as of March 31, 2007, the results of operations for the three months ended March 31, 2007 and 2006, and cash flows for the three months ended March 31, 2007 and 2006. For a more complete understanding of our operations, financial position and accounting policies, these consolidated unaudited financial statements and the notes thereto should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2006, previously filed with the SEC on March 19, 2007.

In the course of preparing the consolidated financial statements, our management makes various assumptions, judgments, and estimates to determine the reported amount of assets, liabilities, revenue and expenses, and in the disclosures of commitments and contingencies. Changes in these assumptions, judgments, and estimates will occur as a result of the passage of time and the occurrence of future events and, accordingly, actual results could differ from amounts initially established.

The more significant areas requiring the use of assumptions, judgments, and estimates relate to volumes of natural gas and oil reserves used in calculating depletion, the amount of expected future cash flows used in determining possible impairments of oil and gas proved and unproved properties, the amount of accrued capital expenditures used in such calculations, future abandonment obligations and non-cash stock-based compensation expense related to the Company's Long Term Incentive Plan.

**Principles of Consolidation**

The consolidated financial statements include the accounts of all of our wholly owned subsidiaries. All inter-company profits, transactions, and balances have been eliminated.

**Inventory Tubular**

Tubular inventory consists primarily of tubular pipe and casing used in our operations and is stated at the lower of average cost or market value.

**Sale of Oil and Gas Properties**

Effective December 31, 2005, the Company entered into an Acreage Earning Agreement (the Earning Agreement ) with Noble Energy, Inc. ( Noble ), which closed on January 27, 2006. Under the terms of the Earning Agreement, Noble would earn a 75% working interest in Teton's Denver-Julesburg ( DJ ) Basin acreage in all acreage within the Area of Mutual Interest ( AMI ) after payment of the \$3,000,000 and after drilling twenty wells by March 1, 2007 at no cost to Teton. Noble paid the Company \$3,000,000 under the Earning Agreement and the Company recorded the entire \$3,000,000 (including \$300,000, which was reflected as a deposit at December 31, 2005) as a reduction of the investment in its DJ Basin property. Teton receives 25% of any net revenues derived from the drilling and completion of the first 20 wells. After completion of the first 20 wells,



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**Notes to Consolidated Financial Statements Continued  
(Unaudited)**

the Earning Agreement provides that Teton and Noble will split all costs associated with future drilling and related facilities according to each party's working interest percentage.

On December 21, 2006, the Company received notification from Noble that the first 20 wells had been drilled and completed for the DJ Basin Niobrara pilot project. Therefore, pursuant to the Earning Agreement, Noble earned 75% of all acreage within the AMI. Teton's interests in the oil and gas rights and leases are recorded directly to Teton DJ Basin LLC, a wholly owned subsidiary of the Company.

**Purchase of Oil and Gas Properties**

On May 5, 2006, we closed a definitive agreement with American Oil and Gas, Inc. (American) acquiring a 25% working interest in approximately 59,000 net acres in the Williston Basin located in North Dakota for a total purchase price of approximately \$6.17 million.

Per the terms of the agreement, we paid American approximately \$2.47 million in cash at closing and additionally agreed to pay approximately \$3.7 million in respect of American's 50% share for drilling and completion of the two planned wells through June 1, 2007. Any portion of the \$3.7 million not expended for drilling and completion by June 1, 2007, will be paid to American on that date. In addition to our obligation to fund American's share, we are also obligated to pay costs in respect of our own 25% share of drilling and completion costs of such wells. As of March 31, 2007, we have paid to American approximately \$3.3 million of the initial obligation of \$3.7 million resulting in a remaining accrued purchase consideration of \$463,074.

In addition to our 25% working interest, we have two partners in the acreage: American, which has a 50% working interest in the acreage, and Evertson Energy Company (Evertson) who is the operator and has a 25% working interest. Evertson began drilling one multi-lateral horizontal well, the Champion 1-25H on September 25, 2006. This well is currently being tested for commerciality.

**Debt Issuance Costs**

Debt issuance costs are amortized to interest expense over the life of the related credit facility using the effective interest method. The Credit Facility currently in place has a term of 48 months maturing June 15, 2010. See Note 3 Long-Term Debt.

**Revenue Recognition**

Oil and natural gas revenue is recognized monthly based on production and delivery. We follow the sales method of accounting for our natural gas and crude oil revenue, so that we recognize sales revenue on all natural gas or crude oil sold to our purchasers at a fixed or determinable price, when delivery has occurred and title has transferred, and if collectibility of the revenue is probable. Processing costs for natural gas that are paid in-kind are deducted from our revenues.

The volume of natural gas sold may differ from the volume to which we are entitled based on our working interest. When this occurs, a gas imbalance is deemed to exist. An imbalance is recognized as a liability only when the estimated remaining reserves will not be sufficient to enable the under-produced owner(s) to recoup its entitled share through future production. Natural gas imbalances can arise on properties for which two or more owners have the right to take production in-kind. In a typical gas balancing arrangement, each owner is entitled to an agreed-upon percentage of a property's total production; however, at any given time, the amount of natural gas sold by each owner may differ from its allowable percentage. Two principal accounting practices have evolved to account for natural gas imbalances. These methods differ as to whether revenue is recognized based on the actual sale of natural gas (sales method) or an owner's entitled share of the current period's production (entitlement method). We have elected to use the sales method. If we used the entitlement method, our future reported revenues may be materially different than those reported under the sales method.

At March 31, 2007, there were no gas imbalances in respect of our oil and gas operations.

**Successful Efforts Method of Accounting**

We account for our crude oil exploration and natural gas development activities utilizing the successful efforts method of accounting. Under this method, costs of productive exploratory wells, development dry holes, productive wells and undeveloped leases are capitalized. Oil and gas lease acquisition costs are also capitalized. Exploration costs,

including personnel costs, certain geological and geophysical expenses and delay rentals for oil and gas leases, are charged to expense as incurred. Exploratory drilling costs are initially capitalized, but charged to expense if and when the well is determined not to have found reserves in commercial quantities. The sale of a partial interest in a proved property is accounted for as a cost recovery and no gain or loss is recognized as long as this treatment does not significantly affect the unit-of-production

**Table of Contents****Notes to Consolidated Financial Statements Continued  
(Unaudited)**

amortization rate. A gain or loss is recognized for all other sales of producing properties.

The application of the successful efforts method of accounting requires managerial judgment to determine the proper classification of wells designated as developmental or exploratory that will ultimately determine the proper accounting treatment of the costs incurred. The results from a drilling operation can take considerable time to analyze and the determination that commercial reserves have been discovered requires both judgment and industry experience. Wells may be completed that are assumed to be productive and actually deliver oil and gas in quantities insufficient to be economic, which may result in the abandonment of the wells at a later date. Wells are drilled that have targeted geologic structures that are both developmental and exploratory in nature. In this case an allocation of costs to the exploratory and development segments is required. Delineation seismic incurred to select development locations within an oil and gas field is typically considered a development cost and capitalized, but often these seismic programs extend beyond the reserve area considered proved and management must estimate the portion of the seismic costs to expense. The evaluation of oil and gas leasehold acquisition costs requires managerial judgment to estimate the fair value of these costs with reference to drilling activity in a given area. Drilling activities in an area by other companies may also effectively condemn leasehold positions.

The successful efforts method of accounting can have a significant impact on the operational results reported when the Company is entering a new exploratory area in an effort to find an oil and gas field that will be the focus of future development drilling activity. The initial exploratory wells may be unsuccessful and will be expensed. Seismic costs can be substantial, which will result in additional exploration expense when incurred. In addition, in the event that wells do not produce economic quantities of oil and or gas an impairment event may occur and part or all of the costs capitalized at that point in time would be expensed.

**Reclassification**

Certain amounts in the 2006 financial statements have been reclassified to conform to the 2007 presentation.

**Income Taxes**

In June 2006, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes ( FIN 48 ). The interpretation creates a single model to address accounting for uncertainty in tax positions. Specifically, the pronouncement prescribes a recognition threshold and a 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 of certain tax positions.

The Company adopted the provisions of FIN 48 on January 1, 2007. The adoption of this accounting principle did not have an effect on the Company's financial statements as of March 31, 2007.

**Recently Issued Accounting Pronouncements**

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements ( SFAS 157 ). The adoption of SFAS 157 is not expected to have a material impact on the Company's consolidated financial position or results of operations. However, additional disclosures may be required about the information used to develop certain fair value measurements. SFAS 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value and requires additional disclosures about fair value measurements. This Standard requires companies to disclose the fair value of their financial instruments according to a fair value hierarchy. SFAS 157 does not require any new fair value measurements, but will remove inconsistencies in fair value measurements between various accounting pronouncements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which permits an entity to measure certain financial assets and financial liabilities at fair value. The objective of SFAS No. 159 is to improve financial reporting by allowing entities to mitigate volatility in reported earnings caused by the measurement of related assets and liabilities using different attributes, without having to apply complex hedge accounting provisions. Under SFAS No. 159, entities that elect the fair value option (by instrument)

will report unrealized gains and losses in earnings at each subsequent reporting date. The fair value option election is irrevocable, unless a new election date occurs. SFAS No. 159 establishes presentation and disclosure requirements to help financial statement users understand the effect of the entity's election on its earnings, but does not eliminate disclosure requirements of other accounting standards. Assets and liabilities that are measured at fair value must be displayed on the face of the balance sheet. This statement is effective beginning January 1, 2008 and we are evaluating this pronouncement.

**Note 2 Earnings per Share**

Basic earnings per common share ( EPS ) are computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that would occur if securities or other contracts to issue common stock were exercised or converted into common stock. All potential dilutive securities have an anti-dilutive effect on earnings (loss) per share and accordingly, basic and dilutive weighted average shares are the same. As of March 31, 2007 a total of 4,592,150 shares of dilutable securities have been excluded from the calculation of EPS as the effect of including these securities would be anti-dilutive.

**Table of Contents****Notes to Consolidated Financial Statements Continued  
(Unaudited)****Note 3 Long-Term Debt**

Long term debt consisted of the following at March 31, 2007 and December 31, 2006 as follows:

	<b>March 31, 2007</b>	<b>December 31, 2006</b>
Credit Facility	\$ 1,000,000	\$

On June 15, 2006, the Company entered into a \$50 million revolving credit facility (the Credit Facility) with BNP Paribas as administrative agent, sole lead arranger, and sole book runner. The Credit Facility matures on June 15, 2010. As of March 31, 2007, the Company advanced \$1.0 million of its Credit Facility. As of May 10, 2007, the Company advanced an additional \$3.0 million for a total outstanding balance of \$4.0 million under its Credit Facility. The Credit Facility provides for as much as \$50 million in borrowing capacity, depending upon a number of factors, such as the projected value of our proven oil and gas assets. The borrowing base for the Credit Facility at any time will be the loan value assigned to the proved reserves attributable to our subsidiaries' direct or indirect oil and gas interests. The Credit Facility has an initial borrowing base of \$3.0 million, and this borrowing base was increased to \$6.0 million on March 12, 2007. The borrowing base will be redetermined on a semi-annual basis, based upon an engineering report delivered by us from an approved petroleum engineer. The Credit Facility is available for working capital requirements, capital expenditures, acquisitions, general corporate purposes and to support letters of credit. Under the Credit Facility, each loan bears interest at a Eurodollar rate or a base rate, as requested by us, plus an additional margin based on the amount of our total outstanding borrowings relative to the total borrowing base. The Eurodollar rate is based on the London Interbank Offered Rate. The base rate is the higher of the Prime Rate or the Federal Funds Rate plus one-half of one percent. In addition, under the terms of the Credit Facility, we are required to pay a commitment fee based on the average daily amount of the unused amount of the commitment of each lender. This fee accrues at a rate of 0.50% per annum and is paid quarterly in arrears on the last day of March, June, September, and December of each year and on the date on which the Credit Facility is terminated. Loans made under the Credit Facility are secured by a first mortgage against the Company's properties, a pledge of the equity of our subsidiaries and a guaranty by those same subsidiaries.

Costs were incurred in connection with our Credit Facility and are considered part of our debt issuance costs and are included in our non-current assets. The remaining unamortized debt issuance costs at March 31, 2007 were \$194,606. Those debt issuance costs are amortized to interest expense over the life of the related credit facility using the effective interest method.

The Credit Facility contains customary affirmative and negative covenants such as minimum/maximum ratios for liquidity and leverage. Under the terms of the Credit Facility, certain covenants are not immediately effective and are phased in beginning at the end of the first quarter of 2007 and are then gradually phased-in over the first three quarters of 2007. On May 11, 2007 the Company entered into a placement agreement with a broker/dealer pursuant to which this broker/dealer will raise \$7.0 million of 8% Senior Subordinated Convertible Unsecured Notes on a best efforts basis. See Note 8 Subsequent Events.

The Company amended its Credit Facility on May 14, 2007. The Second Amendment provides for the total debt to EBITDAX (Earnings Before Interest, Taxes, Depreciation And Amortization And Exploration) ratio to be effective September 30, 2007.

The \$1.0 million outstanding on the Credit Facility as of March 31, 2007 and the \$3.0 million that was subsequently drawn are both due on June 15, 2010. The 8% Senior Subordinated Unsecured Notes are due May 15, 2008.

**Note 4 Stockholders' Equity**

Our authorized capital stock consists of 250,000,000 shares of common stock, \$.001 par value per share (the Common Stock) and 25,000,000 shares of preferred stock, \$.001 par value per share (the Preferred Stock).

During the three months ended March 31, 2007, holders of the Company's Common Stock options exercised 510,880 options, and purchased an equivalent number of the Company's Common Stock. The Company collected proceeds of



\$1,828,754 during the first quarter of 2007 in respect to the exercise of these stock options. See Note 5 Stock-based Compensation for additional information on stock options.

During the three months ended March 31, 2007, the Company issued 426,518 restricted shares which were awarded to directors, officers and employees under the 2005 LTIP plan for 2006 year milestone achievements. In addition, the Company issued 70,001 restricted shares of common stock that vested during the year ended December 31, 2006. See Note 5 Stock-based Compensation for additional information on restricted Common Stock.

In connection with the resignation of our former contract Chief Financial Officer, effective March 31, 2006, 50,000 restricted shares of Common Stock were returned to us as an agreed-upon reduction in service fees charged. The return of such shares had been recorded as a reduction in accounting fees totaling \$157,500 at March 31, 2006.

**Table of Contents****Notes to Consolidated Financial Statements Continued  
(Unaudited)**

In respect to warrants, the following table presents the activity for warrants outstanding for the three months ended March 31, 2007:

	<b>Shares</b>	<b>Weighted Average Exercise Price</b>
Outstanding December 31, 2006	867,819	\$ 3.14
Granted		
Exercised		
Forfeited/canceled		
Outstanding March 31, 2007	867,819	\$ 3.14

The following table presents the composition of warrants outstanding and exercisable as of March 31, 2007:

<b>Range of Exercise Prices</b>	<b>Number</b>	<b>Price*</b>	<b>Life*</b>
\$1.75 - \$3.24	861,819	\$ 3.13	4.3
\$3.48 - \$4.35	6,000	3.81	1.3
Total shares outstanding and exercisable	867,819	\$ 3.14	4.3

\* Price and Life reflect the weighted average exercise price and weighted average remaining contractual life (in years), respectively.

**Note 5 Stock-based Compensation**

At the Company's 2005 Annual Meeting, the stockholders approved a Long Term Incentive Plan (the "LTIP"). The LTIP is a performance-based compensation plan whereby up to 10% of the outstanding shares at the beginning of each plan year, except for the first year wherein 20% of the outstanding shares are available (not to exceed, in any three year period, 35% of the outstanding shares of the Company) can be awarded to certain employees, directors and consultants. In most cases, awards will be linked to the performance of the Company as measured by performance metrics that, at the time of the grants, are deemed necessary by the Compensation Committee of the Board of Directors for the creation of shareholder value.

On July 26, 2005, the Compensation Committee finalized the award of 800,000 performance share units to certain Company employees and directors which vest during each of 2005, 2006 and 2007 provided the Company meets certain performance targets as established by the Committee. The vesting of the performance share units into common stock is conditioned on the participants remaining employed by the Company at each measurement date and will vest over one, two and three year periods. The performance share units will vest into common stock on a sliding scale from

50% to 200%, depending on the performance levels achieved by the Company. No LTIP shares were earned for the 2005 year as the objectives established by the Compensation Committee were not met.

During 2006, the Compensation Committee reserved 2,500,000 performance share units under the LTIP to executives, directors, certain employees and consultants which vest during each of 2006, 2007 and 2008 provided the Company meets certain performance targets as established by the Committee. The vesting of the performance share units into common stock is conditioned on the participants remaining employed by the Company at each measurement date and will vest over one, two and three year periods. The performance share units will vest into common stock on a sliding scale from 50% to 200%, depending on the performance levels achieved by the Company. On March 13, 2007, based on the achievement of a 150% composite index for grants reserved for 2006, 291,750 shares were earned and awarded to directors, employees and consultants.

A summary of the stock-based compensation expense recognized in the results of operations is set forth below:

	<b>Three Months Ended March</b>	
	<b>31,</b>	
	<b>2007</b>	<b>2006</b>
LTIP performance share units directors, employees and consultants	\$ 741,179	\$ 380,685
Restricted common stock directors, employees and consultants	148,473	98,475
Stock options	4,383	9,863
<b>Total</b>	<b>\$ 894,035</b>	<b>\$ 489,023</b>

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Each of the component categories of stock-based compensation is described more fully below.

*Stock Options*

We granted 45,000 stock options during 2006 under the 2003 Employee Stock Option Plan. These options are exercisable at \$3.11 per share and vest over a three-year period, assuming the employees remain in our employ. As of March 31, 2007, we estimated the unrecognized value of the stock options at \$21,916 using the Black-Scholes option-pricing model with the following assumptions: volatility of 109.46%, a risk-free rate of approximately 4%, zero dividend payments and a life of 10 years. As of March 31, 2007, there were 10,033 unvested stock options outstanding, and the total unrecognized compensation cost adjusted for estimated forfeitures related to non-vested options was \$21,916, which is expected to be recognized over the remaining service period of 15 months.

A summary of stock option activity for the three months ended March 31, 2007 is set forth below:

	Number Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2006	2,088,545	\$ 3.56		
Granted		\$		
Exercised	(510,880)	\$ 3.58		
Forfeited/expired		\$		
Outstanding at March 31, 2007	1,577,665	\$ 3.55	5.91	\$ 2,148,373
Exercisable at March 31, 2007	1,564,332	\$ 3.55	5.91	\$ 2,124,373

*Long Term Incentive Plan*

On June 28, 2005, the Company's shareholders approved a long-term incentive plan (the "LTIP") that permits the grant of stock options, stock appreciation rights, performance share units, and restricted share units to employees, directors, consultants and vendors as directed by the Compensation Committee of the Board of Directors, with management recommendations regarding consultants, vendors, and non-executive employees.

The Compensation Committee establishes a pool ("Pool") of Performance Share Units ("Units") under the LTIP each year (each year becoming a "Grant Year"), subject to limits set forth in the LTIP, and allocates the pool to officers, directors, employees and consultants, and grants units ("Grants") to individual participants. The Grants vest over a period of time, typically over a three-year period. In addition to vesting based on a participant's continued employment with or service to the Company over the period of a Grant, the Units must be earned based on achieving performance goals set forth by the Compensation Committee. The Compensation Committee designates performance levels as Threshold, Base, and Stretch. If the Company achieves 100% of the Base level of performance, 100% of the Units vesting in that year will be earned. If the Company achieves the Threshold level of performance, 50% of the Units will be earned. If the Company achieves the Stretch level of performance, 200% of the Units will be earned. If the Threshold performance is not achieved, no Units are earned. Units may not be earned above the 200% Stretch level. Once the Units are vested and earned, they are released to the participants as common stock.

The value of each Unit is measured and determined based on the value of the Company's common stock at the date the Unit is granted. Annual compensation expense is calculated based upon the number of Units vested and earned each year. Each quarter the Company estimates the level of performance expected to be achieved by year-end and records an estimated expense accordingly.

During the third quarter of 2005 (the 2005 Grant Year ) the Compensation Committee established a Pool of 400,000 Base Units and 800,000 Stretch Units (the 2005 Grants ). During 2005, grants of 372,500 Base Unit awards were made. The Units vest in three tranches (20% in 2005, 30% in 2006 and 50% in 2007), provided the goals set forth by the Compensation Committee are met. The performance goals are based upon attaining specific objectives, including: (a) achieving certain levels of oil and gas reserves in each year of the grant, (b) achieving a certain level of oil and gas production in each year of the grant, (c) achieving a certain level of stock price performance in each year of the Grant, (d) maintaining finding and development costs within certain ranges during each year of the grant and (e) management s

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efficiency and effectiveness in its operations. On March 13, 2007, based on the achievement of a 126.54% composite index in respect of the milestones established for 2006 under the 2005 Grants, 134,768 shares were earned and awarded, to directors, employees and consultants.

In December 2005, the Compensation Committee reserved for 2006 (the 2006 Grant Year ) 1,000,000 Base Units and 2,000,000 Stretch Units (the 2006 Grants ). In March 2006, the Compensation Committee increased the Pool of Base Units being reserved to 1,250,000 and Stretch Units to 2,500,000 to accommodate anticipated executive hires. At December 31, 2006, a total of 984,625 Base Units and 1,969,250 Stretch Units had been granted, but not yet earned or vested. The remainder of Units in the 2006 Pool reverted to shares deemed available for future issuance, consistent with the terms of the LTIP.

The 2006 Grants vest in three tranches (20% in 2006, 30% in 2007 and 50% in 2008), provided the goals set forth by the Compensation Committee are met. The performance objectives established by the Compensation Committee for the 2006 Grants are based on the (a) value of completed acquisitions in each year of the Grant relative to the Company's market capitalization at the end of the previous calendar year, (b) stock price performance relative to an index of comparable companies over the period of the Grant established by an independent third party, and (c) management's efficiency and effectiveness in its operations. These objectives represent 100% of the goals for senior executives of the Company and varying but lesser percentages for other employees, whose vesting includes a combination of individual, team, and corporate obje