

CARBON ENERGY CORP  
Form 10-Q  
August 19, 2002

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended June 30, 2002

Or

o **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: 1-15639

**CARBON ENERGY CORPORATION**

(Exact name of registrant as specified in its charter)

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

**84-1515097**  
(I.R.S. Employer  
Identification No.)

**1700 Broadway, Suite 1150, Denver, CO**  
(Address of principal executive offices)

**80290**  
(Zip Code)

**(303) 863-1555**

(Registrant's telephone number, including area code)

**Not Applicable**

(Former name, former address and former fiscal year, if changed since last report)

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 ý No o

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

Class	Outstanding at August 12, 2002
Common stock, no par value	6,141,090 shares

**CARBON ENERGY CORPORATION  
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**PART I FINANCIAL INFORMATION**

**Item 1. FINANCIAL STATEMENTS**

**CARBON ENERGY CORPORATION  
CONSOLIDATED BALANCE SHEETS**

(in thousands)

(unaudited)

	<b>June 30, 2002</b>	<b>December 31, 2001</b>
<b>ASSETS</b>		
Current assets:		
Cash	\$	\$
Accounts receivable, trade	2,417	2,258
Accounts receivable, other	55	53
Prepaid expenses and other	445	317
Current derivative asset	77	341
	2,994	2,969
Total current assets	2,994	2,969

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	June 30, 2002	December 31, 2001
	<u>          </u>	<u>          </u>
Property and equipment, at cost:		
Oil and gas properties, using the full cost method of accounting:		
Unproved properties	8,286	7,500
Proved properties	67,800	62,750
Furniture and equipment	935	927
	<u>          </u>	<u>          </u>
	77,021	71,177
Less accumulated depreciation, depletion and amortization	(29,124)	(12,226)
	<u>          </u>	<u>          </u>
Property and equipment, net	47,897	58,951
	<u>          </u>	<u>          </u>
Deposits and other long-term assets	538	448
	<u>          </u>	<u>          </u>
Total assets	\$ 51,429	\$ 62,368
	<u>          </u>	<u>          </u>

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

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**CARBON ENERGY CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**

(in thousands)

(unaudited)

	June 30, 2002	December 31, 2001
	<u>          </u>	<u>          </u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 3,763	\$ 5,113
Accrued production taxes payable	480	527
Income taxes payable		1,168
Undistributed revenue and other	1,136	1,062
Current derivative liability	252	76
Deferred income taxes		74
	<u>          </u>	<u>          </u>
Total current liabilities	5,631	8,020
	<u>          </u>	<u>          </u>
Long-term debt	23,296	17,870
Other long-term liabilities	113	18
Deferred income taxes	2,904	2,577
Minority interest	28	29

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	June 30, 2002	December 31, 2001
	<u>          </u>	<u>          </u>
Stockholders' equity:		
Preferred stock, no par value:		
10,000,000 shares authorized, none outstanding		
Common stock, no par value:		
20,000,000 shares authorized, issued, and 6,104,092 shares and 6,079,225 shares outstanding at June 30, 2002 and December 31, 2001, respectively	31,933	31,799
Retained earnings (accumulated deficit)	(12,083)	2,538
Accumulated other comprehensive loss	(393)	(483)
	<u>          </u>	<u>          </u>
Total stockholders' equity	19,457	33,854
	<u>          </u>	<u>          </u>
Total liabilities and stockholders' equity	\$ 51,429	\$ 62,368
	<u>          </u>	<u>          </u>

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

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**CARBON ENERGY CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share data)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Revenues:				
Oil and gas sales	\$ 4,036	\$ 5,751	\$ 7,584	\$ 13,367
Marketing and other, net	101	565	179	1,252
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
	4,137	6,316	7,763	14,619
Expenses:				
Oil and gas production costs	1,226	1,261	2,411	2,629
Depreciation, depletion and amortization	1,697	1,448	3,437	2,836
Full cost ceiling impairment	13,218		13,218	
General and administrative, net	1,161	1,218	2,490	2,314
Interest and other, net	260	224	453	410
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total operating expenses	17,562	4,151	22,009	8,189
Minority interest	1	(3)	1	(25)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Income (loss) before income taxes	(13,424)	2,162	(14,245)	6,405
Income tax provision:				
Current	33	769	60	1,488
Deferred	632	89	316	1,087

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	Three Months Ended June 30,		Six Months Ended June 30,	
Total taxes	665	858	376	2,575
Net income (loss) before cumulative effect of change in accounting principle	(14,089)	1,304	(14,621)	3,830
Cumulative effect of change in accounting principle, net of tax				(1,510)
Net income (loss)	\$ (14,089)	\$ 1,304	\$ (14,621)	\$ 2,320
Average number of common shares outstanding:				
Basic	6,097	6,048	6,091	6,037
Diluted	6,097	6,336	6,091	6,291
Earnings (loss) per share basic:				
Net income (loss) before cumulative effect of change in accounting principle	\$ (2.31)	\$ 0.22	\$ (2.40)	\$ 0.63
Cumulative effect of change in accounting principle, net of tax				(0.25)
	\$ (2.31)	\$ 0.22	\$ (2.40)	\$ 0.38
Earnings (loss) per share diluted:				
Net income (loss) before cumulative effect of change in accounting principle	\$ (2.31)	\$ 0.21	\$ (2.40)	\$ 0.61
Cumulative effect of change in accounting principle, net of tax				(0.24)
	\$ (2.31)	\$ 0.21	\$ (2.40)	\$ 0.37

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

**CARBON ENERGY CORPORATION**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

	For the Six Months Ended June 30,	
	2002	2001
Cash flows from operating activities:		
Net income (loss)	\$ (14,621)	\$ 2,320
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation, depletion and amortization expense	3,437	2,836
Full cost ceiling impairment	13,218	

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	For the Six Months Ended June 30,	
Amortization of deferred hedging gains	(122)	
Unrealized derivative gains		(1,116)
Deferred income tax	316	1,087
Cumulative effect of change in accounting principle		1,510
Minority interest	(1)	25
Vesting of restricted stock grants	77	63
Changes in operating assets and liabilities:		
Decrease (increase) in:		
Accounts receivable	78	1,135
Amounts due from broker		3,164
Prepaid expenses and other assets	(77)	49
Increase (decrease) in:		
Accounts payable and accrued expenses	(2,871)	(3,620)
Undistributed revenue	55	32
Net cash provided by (used in) operating activities	(511)	7,485
Cash flows from investing activities:		
Capital expenditures for oil and gas properties	(4,747)	(11,256)
Proceeds from property sales	2	6,758
Acquisition of CEC Resources	(6)	(203)
Capital expenditures for support equipment		(464)
Net cash used in investing activities	(4,751)	(5,165)
Cash flows from financing activities:		
Proceeds from notes payable	14,495	30,796
Principal payments on notes payable	(9,300)	(33,227)
Proceeds from issuance of common stock	57	157
Net cash provided by (used in) financing activities	5,252	(2,274)
Effect of exchange rate changes on cash	10	(67)
Net increase (decrease) in cash		(21)
Cash, beginning of period		21
Cash, end of period	\$	\$
Supplemental cash flow information:		
Cash paid for interest	\$ 444	\$ 538
Cash paid for taxes	1,308	384

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

**CARBON ENERGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Nature of Operations**

*Nature of Operation* Carbon Energy Corporation (Carbon) is an oil and gas company engaged in the exploration, development and production of natural gas and crude oil in the United States and Canada. The Company's exploration and production areas in the United States include the Piceance Basin in Colorado, the Uintah Basin in Utah, the Permian Basin in New Mexico, Kansas and Montana. The Company's exploration and production areas in Canada include Central Alberta and Southeast Saskatchewan.

Carbon was incorporated in September 1999 under the laws of the State of Colorado to facilitate the acquisition of Bonneville Fuels Corporation (BFC) and subsidiaries. The acquisition of BFC closed on October 29, 1999 and was accounted for as a purchase. In February 2000, Carbon completed an offer to exchange shares of Carbon for shares of CEC Resources Ltd. (CEC), an Alberta, Canada company. The exchange offer resulted in the issuance of 1,482,826 shares of Carbon stock in exchange for over 97% of the outstanding CEC shares. The acquisition closed on February 17, 2000 and was also accounted for as a purchase. In November 2000, CEC initiated an offer to purchase additional shares of CEC. The offer was completed in February 2001 with the acquisition of approximately 34,000 shares of CEC stock. Carbon currently owns 99.7% of the stock of CEC. On July 11, 2002, Carbon changed the name of BFC to Carbon Energy Corporation (USA) (Carbon USA). Collectively, Carbon, CEC, Carbon USA and its subsidiaries are referred to as the Company.

All amounts are presented in U.S. dollars.

The unaudited financial statements presented herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). The statements do not include certain information and note disclosures required by accounting principles generally accepted in the United States for complete financial statements. The accompanying consolidated financial statements of the Company should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K, for the year ended December 31, 2001, as filed with the SEC. The statements reflect all adjustments that, in the opinion of management, are necessary to fairly present the Company's financial position at June 30, 2002 and the results of operations and cash flows for the periods presented.

**2. Significant Accounting Policies**

*Principles of Consolidation* The consolidated financial statements include the accounts of Carbon and its subsidiaries all of which are wholly owned, except CEC, of which the Company owns approximately 99.7%. All significant intercompany transactions and balances have been eliminated.

*Cash Equivalents* The Company considers liquid instruments with original maturities when purchased of three months or less to be cash equivalents.

*Property and Equipment* The Company follows the full cost method of accounting for its oil and gas properties. All costs incurred in the acquisition, exploration and development of properties (including costs of surrendered and abandoned leaseholds, delay lease rentals, dry holes and direct overhead related to exploration and development activities) are capitalized.

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Capitalized costs are accumulated for the United States and Canada as separate cost centers and are depleted using the units of production method based on proved reserves of oil and gas. For purposes of the depletion calculation, oil and gas reserves are converted to an equivalent unit of measure where six thousand cubic feet of gas is equal to one barrel of oil. The estimated future cost of site restoration, dismantlement and abandonment activities is provided for as a component of depletion. Investments in unproved properties are recorded at the lower of cost or fair market value and are not depleted pending the determination of the existence of proved reserves.

Pursuant to full cost accounting rules, total capitalized costs less related accumulated depletion and deferred income taxes may not exceed the sum of the present value of future net revenues from estimated production of proved oil and gas reserves using a 10% discount factor and un-escalated oil and gas prices and costs as of the end of the period; plus the cost of properties not being amortized, if any; plus the lower of cost

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or estimated fair value of unproved properties included in the costs being amortized, if any; less related income tax effects. At June 30, 2002, the Company's capitalized costs exceeded the ceiling limitation in the United States and Canada by \$14.0 million and \$2.4 million, respectively. When pricing at June 30, 2002 is adjusted for oil and natural gas hedges in place at June 30, 2002, the Company's capitalized costs exceeded the ceiling limitation in the United States and Canada by \$12.0 million and \$1.2 million, respectively. Accordingly, the Company recorded a \$12.0 million and \$1.2 million non-cash charge in the United States and Canada, respectively, to reflect the impairments. The impairments are included as additional accumulated DD&A in the accompanying balance sheet. Due to the volatility of commodity prices, should natural gas and crude oil prices decline in the future, even if only for a brief period of time, it is possible that additional impairments of oil and gas properties could occur.

Proceeds from disposal of interests in oil and gas properties are accounted for as adjustments of capitalized costs with no gain or loss recognized, unless such adjustments would significantly alter the rate of depletion.

Buildings, transportation and other equipment are depreciated on the straight-line method with lives ranging from three to seven years.

*Undistributed Revenue* Represents revenue due to other owners of jointly owned oil and gas properties.

*Revenue Recognition* The Company follows the sales method of accounting for natural gas revenues. Under this method, revenues are recognized based on the actual volume of gas sold to purchasers. To the extent the volumes of gas sold are more (overproduced) or less (underproduced) than the volumes to which the Company is entitled based on its interests in its properties, a gas imbalance may be created. If the estimated remaining reserves of a property will not be sufficient to enable the underproduced owner to recoup its share of production, revenue is deferred and a liability is created.

*Income Taxes* The Company accounts for income taxes using the liability method which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the book and tax basis of assets and liabilities using tax rates in effect for the year in which the differences are expected to reverse.

*Commodity Derivative Instruments and Hedging Activities* The Company may use certain financial instruments including swaps, collars, futures and other contracts in an attempt to reduce exposure to market fluctuations in the price of oil and natural gas.

Pursuant to Company guidelines, the Company is to engage in these activities only as a hedging mechanism and may not enter into speculative transactions. The Company has a Risk Management

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Committee to administer and approve all production hedging transactions. Gains or losses from financial instruments that qualify for hedge accounting treatment are recognized as an adjustment to sales revenue in the period in which the financial instrument matures. Gains or losses from financial instruments that do not qualify for hedge accounting treatment are recognized in the current period as other income or expense. The cash flows from such agreements are included in operating activities in the consolidated statements of cash flows. The following table sets forth the hedge gains/(losses) realized by the Company for the three months and six months ended June 30, 2002 and 2001 (in thousands):

	United States		Canada		United States		Canada	
	Three Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001	2002	2001	2002	2001
Oil	\$ (16)	\$	\$	\$	\$ (16)	\$	\$ 11	\$
Natural gas	13	(757)	(79)	(202)	64	(1,287)	16	(921)

The table below sets forth the Company's derivative financial instrument positions relating to its natural gas and oil production that qualify for hedge accounting treatment at June 30, 2002:

Swaps:

Carbon USA Contracts

CEC Contracts



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Carbon USA Contracts				CEC Contracts			
Time Period	Bbl/ MMBtu	Weighted Average Fixed Price Bbl/ MMBtu	Derivative Asset/ (Liability)	Time Period	MMBtu	Weighted Average Fixed Price MMBtu	Derivative Asset/ (Liability)
(in thousands)				(in thousands)			
<b>Gas</b>				<b>Gas</b>			
07/01/02 - 12/31/02	460,000	\$ 2.46	\$ 121	07/01/02 - 12/31/02	378,000	\$ 2.52	\$ (46)
01/01/03 - 06/30/03	455,500	3.08	(102)	01/01/03 - 12/31/03	216,000	2.92	(95)
<b>Oil</b>							
07/01/02 - 12/31/02	18,400	\$ 24.55	\$ (24)				
01/01/03 - 03/31/03	9,000	24.55	(4)				

Collars:

CEC Contracts

Time Period	Bbl/ MMBtu	Average floor Bbl/ MMBtu	Average Ceiling Bbl/ MMBtu	Derivative Asset/ (Liability)
(in thousands)				
<b>Gas</b>				
07/01/02 - 10/31/02	117,000	\$ 2.50	\$ 3.52	\$ 39
<b>Oil</b>				
07/01/02 - 12/31/02	18,400	\$ 22.00	\$ 27.50	\$ (13)

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In addition to the derivative contracts discussed above, the Company may enter into long-term sales contracts for a portion of its natural gas and oil production. The table below sets forth fixed price sales contracts at June 30, 2002:

Fixed price contracts:

Carbon USA Contracts			CEC Contracts		
Time Period	MMBtu	Weighted Average Fixed Price MMBtu	Time Period	MMBtu	Weighted Average Fixed Price MMBtu
<b>Gas</b>			<b>Gas</b>		
07/01/02 - 12/31/02	184,000	\$ 2.60	01/01/03 - 12/31/03	365,000	\$ 3.38
01/01/03 - 03/31/03	90,000	2.60			

During the first six months of 2002, net hedging gains of \$91,000 (\$55,000 after tax) were transferred from accumulated other comprehensive income to earnings. The change in the fair market value of outstanding derivative contracts designated as hedges decreased by \$659,000 (\$389,000 after tax). Oil and natural gas prices reflective of the Company's hedge contracts were correlative with the published indices used to sell the Company's production. As a result, no ineffectiveness was recognized related to the Company's hedge contracts during the first six months of 2002. As of June 30, 2002, the Company had net unrealized derivative losses of \$322,000 (\$194,000 after tax). Based on future indices for oil, natural gas and interest rates in effect on June 30, 2002, the Company expects to reclassify \$209,000 of these net unrealized losses to earnings during the next twelve month period.

*Interest Rate Swap Agreements* During 2002, the Company entered into interest rate swap agreements that effectively convert a portion of its variable rate borrowings in the United States to fixed rate debt for periods of up to two years, reducing the impact of interest rate increases on future income. Gains or losses from financial instruments that qualify for hedge accounting treatment are recognized as an adjustment to interest expense in the period in which the financial instrument matures. Gains or losses from interest rate swaps that do not qualify for hedge accounting

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treatment are recognized in the current period as other income or expense. The cash flows from such agreements are included in operating activities in the consolidated statements of cash flow. The table below sets forth the Company's interest rate derivative contracts in place at June 30, 2002:

Notional Amount	Contract Expiration Date	LIBOR Fixed Rate	All-In LIBOR Fixed Rate	Derivative Asset/ (Liability)
(in thousands)				
\$ 3,700	May 2003	3.46%	5.21%	\$ (50)
2,000	October 2003	3.77%	5.52%	(40)
800	October 2003	3.82%	5.57%	(17)
1,000	March 2004	4.15%	5.90%	(22)
2,500	April 2004	4.24%	5.99%	(68)

*Foreign Currency Translation* Foreign currency transactions and financial statements are translated in accordance with SFAS No. 52, "Foreign Currency Translation." The Company uses the U.S. dollar as the functional currency for its U.S. operations and the Canadian dollar as the functional currency for its Canadian operations. Assets and liabilities related to the Company's Canadian operations are generally translated at the current exchange rate in effect as of the date of the balance sheet. Translation adjustments are reported as a component of stockholders' e