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ENCORE ACQUISITION CO
Form 10-Q
May 08, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2003

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 No. 1-16295

ENCORE ACQUISITION COMPANY
(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

75-2759650

(I.R.S. Employer
Identification Number)

777 Main Street, Suite 1400, Ft. Worth, Texas

(Address of principal executive offices)

76102

(Zip code)

Registrant's telephone number, including area code: (817) 877-9955

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 / / No / /

Indicate by check mark whether the registrant is an accelerated filer (as
defined in Rule 12b-2 of the Exchange Act).

Yes / / No / /

Number of shares of Common Stock outstanding as of May 2, 2003.....30,208,215

ENCORE ACQUISITION COMPANY

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ENCORE ACQUISITION COMPANY

CONSOLIDATED BALANCE SHEETS (in thousands except share data)

| | MARCH 31, 2003 | DECEMBER 31, 2002 |
|---|-------------------|----------------------|
| | ----- | ----- |
| | (unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents..... | \$ 8,366 | \$ 13,057 |
| Accounts receivable (Net of allowance of \$0 and \$7.0 million, respectively)..... | 26,111 | 21,981 |
| Deferred tax asset..... | 3,930 | 4,833 |
| Derivative assets..... | 7,065 | 3,245 |
| Other current assets..... | 7,233 | 6,349 |
| | ----- | ----- |

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| | | |
|--|------------|------------|
| Total current assets..... | 52,705 | 49,465 |
| | ----- | ----- |
| Properties and equipment, at cost -- successful efforts method: | | |
| Producing properties..... | 608,533 | 581,012 |
| Undeveloped properties..... | 1,227 | 1,168 |
| Accumulated depletion, depreciation, and amortization.... | (99,822) | (94,356) |
| | ----- | ----- |
| | 509,938 | 487,824 |
| | ----- | ----- |
| Other property and equipment..... | 3,475 | 3,680 |
| Accumulated depreciation and amortization..... | (2,078) | (1,917) |
| | ----- | ----- |
| | 1,397 | 1,763 |
| | ----- | ----- |
| Other assets | 8,858 | 10,844 |
| | ----- | ----- |
| Total assets..... | \$ 572,898 | \$ 549,896 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable..... | \$ 7,003 | \$ 9,650 |
| Derivative liabilities..... | 6,220 | 8,558 |
| Other current liabilities..... | 21,799 | 18,768 |
| | ----- | ----- |
| Total current liabilities..... | 35,022 | 36,976 |
| | ----- | ----- |
| Derivative liabilities..... | 1,397 | 2,998 |
| Long-term debt..... | 158,000 | 166,000 |
| Future abandonment liability..... | 4,871 | -- |
| Deferred income taxes..... | 57,349 | 47,656 |
| | ----- | ----- |
| Total liabilities..... | 256,639 | 253,630 |
| | ----- | ----- |
| Commitments and contingencies..... | -- | -- |
| Stockholders' equity: | | |
| Preferred stock, \$.01 par value, 5,000,000 shares authorized, none issued and outstanding..... | -- | -- |
| Common stock, \$.01 par value, 60,000,000 authorized, 30,208,048 and 30,162,955 issued and outstanding..... | 302 | 302 |
| Additional paid-in capital..... | 251,795 | 251,231 |
| Deferred compensation..... | (2,082) | (2,396) |
| Retained earnings..... | 71,702 | 53,724 |
| Accumulated other comprehensive income..... | (5,458) | (6,595) |
| | ----- | ----- |
| Total stockholders' equity..... | 316,259 | 296,266 |
| | ----- | ----- |
| Total liabilities and stockholders' equity..... | \$ 572,898 | \$ 549,896 |
| | ===== | ===== |

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

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ENCORE ACQUISITION COMPANY

CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands except per share data)

| | THREE MONTHS ENDED MARCH 31, | |
|---|---------------------------------|-----------|
| | 2003 | 2002 |
| | (unaudited) | |
| Revenues: | | |
| Oil..... | \$ 46,432 | \$ 26,686 |
| Natural gas..... | 9,355 | 5,611 |
| Total revenues..... | 55,787 | 32,297 |
| Expenses: | | |
| Production-- | | |
| Lease operations..... | 8,953 | 6,817 |
| Production, ad valorem, and severance taxes..... | 6,169 | 3,013 |
| General and administrative (excluding non-cash stock based compensation)..... | 2,450 | 1,493 |
| Non-cash stock based compensation..... | 145 | -- |
| Depletion, depreciation, and amortization..... | 7,783 | 8,559 |
| Derivative fair value gain..... | (1,260) | (653) |
| Other operating..... | 170 | 139 |
| Total expenses..... | 24,410 | 19,368 |
| Operating income..... | 31,377 | 12,929 |
| Other income (expenses): | | |
| Interest..... | (4,171) | (1,492) |
| Other..... | 47 | 30 |
| Total other income (expenses)..... | (4,124) | (1,462) |
| Income before income taxes and accounting change..... | 27,253 | 11,467 |
| Provision for income taxes - current..... | (767) | (430) |
| Provision for income taxes - deferred..... | (9,371) | (3,927) |
| Income before accounting change..... | 17,115 | 7,110 |
| Cumulative effect of accounting change (net of income taxes of \$329 and \$0, respectively)..... | 863 | -- |
| Net income | \$ 17,978 | \$ 7,110 |
| Income per common share before accounting change: | | |
| Basic..... | \$ 0.57 | \$ 0.24 |
| Diluted..... | \$ 0.57 | \$ 0.24 |

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| | | | |
|--|----|--------|---------|
| Net income per common share: | | | |
| Basic..... | \$ | 0.60 | \$ 0.24 |
| Diluted..... | \$ | 0.59 | \$ 0.24 |
| Weighted average common shares outstanding:..... | | | |
| Basic..... | | 30,037 | 30,030 |
| Diluted..... | | 30,221 | 30,052 |

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

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ENCORE ACQUISITION COMPANY

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
MARCH 31, 2003
(in thousands)
(unaudited)

| | Common Stock | Additional Paid-In Capital | Deferred Compensation | Retained Earnings | Acco Comp I |
|--|-----------------|----------------------------------|--------------------------|----------------------|-------------------|
| | ----- | ----- | ----- | ----- | ----- |
| Balance at December 31, 2002..... | \$ 302 | \$ 251,231 | \$ (2,396) | \$ 53,724 | \$ |
| Exercise of stock options..... | -- | 733 | -- | -- | |
| Deferred compensation: | | | | | |
| Amortization of expense..... | -- | -- | 145 | -- | |
| Other changes..... | -- | (169) | 169 | -- | |
| Components of comprehensive income: | | | | | |
| Net income..... | -- | -- | -- | 17,978 | |
| Change in deferred hedge loss (net of income taxes of \$697). | -- | -- | -- | -- | |
| Total comprehensive income | | | | | |
| Balance at March 31, 2003..... | \$ 302 | \$ 251,795 | \$ (2,082) | \$ 71,702 | \$ |

The accompanying notes are an integral part of these consolidated financial s

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ENCORE ACQUISITION COMPANY

CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

THREE MONTHS ENDED
MARCH 31,

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| | 2003 | 2002 |
|---|-------------|----------|
| | (unaudited) | |
| Operating activities | | |
| Net income..... | \$ 17,978 | \$ 7,110 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depletion, depreciation, and amortization..... | 7,783 | 8,559 |
| Deferred taxes..... | 9,371 | 3,927 |
| Non-cash stock based compensation..... | 145 | -- |
| Cumulative change in accounting principle..... | (863) | -- |
| Derivative fair value gain..... | (613) | (653) |
| Other non-cash items..... | 1,891 | (470) |
| Loss on disposition of assets..... | 124 | 147 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable..... | (4,130) | (3,228) |
| Other current assets..... | (1,328) | (700) |
| Other assets..... | (112) | 4,855 |
| Accounts payable and other current liabilities..... | (4,538) | (2,303) |
| Cash provided by operating activities..... | 25,708 | 17,244 |
| Investing activities | | |
| Proceeds from disposition of assets..... | 395 | 35 |
| Purchases of other property and equipment..... | (36) | (323) |
| Acquisition of oil and gas properties..... | (60) | (50,438) |
| Development of oil and gas properties..... | (23,431) | (20,357) |
| Cash used by investing activities..... | (23,132) | (71,083) |
| Financing activities | | |
| Proceeds from long-term debt..... | 15,000 | 76,000 |
| Payments on long-term debt..... | (23,000) | (21,000) |
| Payments on note payable..... | -- | (1,107) |
| Exercise of stock options..... | 733 | -- |
| Cash provided (used) by financing activities..... | (7,267) | 53,893 |
| Increase (decrease) in cash and cash equivalents..... | (4,691) | 54 |
| Cash and cash equivalents, beginning of period..... | 13,057 | 115 |
| Cash and cash equivalents, end of period..... | \$ 8,366 | \$ 169 |

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

ENCORE ACQUISITION COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. FORMATION OF ENCORE

Encore Acquisition Company ("Encore"), a Delaware corporation, is an

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independent (non-integrated) oil and natural gas company in the United States. We were organized in April 1998 and are engaged in the acquisition, development, exploitation and production of North American oil and natural gas reserves. Our oil and natural gas reserves are concentrated in fields located in the Williston Basin of Montana and North Dakota, the Permian Basin of Texas and New Mexico, the Anadarko Basin of Oklahoma, the Powder River Basin of Montana, and the Paradox Basin of Utah.

2. BASIS OF PRESENTATION

In the opinion of management, the accompanying unaudited consolidated financial statements of Encore include all adjustments necessary to present fairly our financial position as of March 31, 2003 and results of operations and cash flows for the three months ended March 31, 2003 and 2002. All adjustments are of a recurring nature. These interim results are not necessarily indicative of results for an entire year.

Certain disclosures have been condensed or omitted from these consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission. Therefore, these financial statements should be read in conjunction with the Company's 2002 consolidated financial statements and related notes thereto included in the Company's Annual Report filed on Form 10-K.

Employee stock options and restricted stock awards are accounted for at intrinsic value under the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). Accordingly, no compensation expense is recorded for stock options that are granted to employees or non-employee directors with an exercise price equal to or above the common stock price on the grant date. If compensation expense for the stock based awards had been determined using the fair value method proscribed in Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation", the Company's net income and net income per share would have been adjusted to the pro forma amounts indicated below (in thousands, except per share amounts):

| | THREE MONTHS ENDED MARCH 31, 2003 ----- | THREE MONTHS ENDED MARCH 31, 2002 ----- |
|--|---|---|
| As Reported: | | |
| Net income | \$ 17,978 | \$ 7,110 |
| Basic net income per common share..... | 0.60 | 0.24 |
| Diluted net income per common share... | 0.59 | 0.24 |
| Non-cash stock based compensation..... | 145 | -- |
| Pro Forma: | | |
| Net income | \$ 17,646 | \$ 6,788 |
| Basic net income per common share..... | 0.59 | 0.23 |
| Diluted net income per common share... | 0.58 | 0.23 |
| Non-cash stock based compensation..... | 477 | 322 |

3. NEW ACCOUNTING STANDARDS

In August 2001, the FASB issued Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations" ("SFAS 143"), which the Company adopted as of January 1, 2003. This statement requires us to record a

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liability in the period in which an asset retirement obligation ("ARO") is incurred, in an amount equal to the discounted estimated fair value of the obligation. Also, upon initial recognition of the liability, we must capitalize additional asset cost equal to the amount of the liability. Thereafter, each quarter, this liability is accreted up to the final cost.

The adoption of SFAS 143 on January 1, 2003 resulted in a cumulative effect adjustment to record (i) a \$4.0 million increase in the carrying values of proved properties, (ii) a \$2.1 million decrease in accumulated depletion, depreciation, and amortization, and (iii) a

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\$5.2 million increase in other non-current liabilities, and (iv) a gain of \$0.9 million, net of tax, as a cumulative effect of accounting change.

The following table shows pro forma net income and basic and diluted earnings per share as if the Company had adopted SFAS 143 as of January 1, 2002 (in thousands, except per share amounts):

| | THREE MONTHS ENDED MARCH 31, 2003 ----- | THREE MONTHS ENDED MARCH 31, 2002 ----- |
|---|---|---|
| As Reported: | | |
| Net income | \$ 17,978 | \$ 7,110 |
| Basic net income per common share..... | 0.60 | 0.24 |
| Diluted net income per common share.... | 0.59 | 0.24 |
| Pro Forma: | | |
| Net income | \$ 17,115 | \$ 7,480 |
| Basic net income per common share..... | 0.57 | 0.25 |
| Diluted net income per common share.... | 0.57 | 0.25 |

The Company's primary asset retirement obligations relate to future plugging and abandonment expenses on our oil and natural gas properties and related facilities disposal. As of March 31, 2003, the Company had \$2.5 million held in an escrow account from which funds are released only for reimbursement of plugging and abandonment expenses on our Bell Creek property. This amount is included in 'Other assets' in the consolidated balance sheet. The following table summarizes the changes in the Company's total estimated liability from the amount recorded upon adoption of SFAS 143 on January 1, 2003 through March 31, 2003 (in thousands):

| | THREE MONTHS ENDED MARCH 31, 2003 ----- |
|---|---|
| Beginning future abandonment liability... | \$ 4,791 |
| Accretion expense..... | 64 |
| Additional liabilities incurred..... | 16 |

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| | |
|--|----------|
| Ending future abandonment liability..... | ----- |
| | \$ 4,871 |
| | ===== |

In April 2002, the FASB issued SFAS 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections". Under Statement 4, all gains and losses from extinguishment of debt were required to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. This Statement eliminates Statement 4 and, thus, the exception to applying Opinion 30 to all gains and losses related to extinguishments of debt. As a result, gains and losses from extinguishment of debt should be classified as extraordinary items only if they meet the criteria in Opinion 30. Applying the provisions of Opinion 30 will distinguish transactions that are part of an entity's recurring operations from those that are unusual or infrequent or that meet the criteria for classification as an extraordinary item. This statement is effective for Encore beginning January 1, 2003. Thus, we will reclassify the extraordinary loss on extinguishment of debt recorded in the second quarter of 2002 to operating income in all future filings.

4. EARNINGS PER SHARE (EPS)

The following table sets forth basic and diluted EPS computations for the three months ended March 31 (in thousands, except per share amounts):

| | THREE MONTHS ENDED | |
|---|--------------------|----------|
| | MARCH 31, | |
| | 2003 | 2002 |
| | ----- | ----- |
| NUMERATOR: | | |
| Income before accounting change..... | \$ 17,115 | \$ 7,110 |
| | ===== | ===== |
| Net income | \$ 17,978 | \$ 7,110 |
| | ===== | ===== |
| DENOMINATOR: | | |
| Denominator for basic earnings per share - | | |
| weighted average shares outstanding..... | 30,037 | 30,030 |
| Effect of dilutive securities..... | 184 | 22 |
| | ----- | ----- |
| Denominator for diluted earnings per share..... | 30,221 | 30,052 |
| | ===== | ===== |

| | | |
|--------------------------------------|---------|---------|
| Basic income per common share before | | |
| accounting change..... | \$ 0.57 | \$ 0.24 |
| Cumulative effect of accounting | | |
| change, net of tax..... | 0.03 | -- |
| | ----- | ----- |
| Basic income per common share after | | |
| accounting change..... | \$ 0.60 | \$ 0.24 |

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| | | |
|---|---------|---------|
| | ===== | ===== |
| Diluted income per common share before | | |
| accounting change..... | \$ 0.57 | \$ 0.24 |
| Cumulative effect of accounting change, | | |
| net of tax..... | 0.02 | -- |
| | ----- | ----- |
| Diluted income per common share after | | |
| accounting change..... | \$ 0.59 | \$ 0.24 |
| | ===== | ===== |

For the quarters ended March 31, 2003 and 2002, outstanding employee stock options of 240,000 and 500,000, respectively, were excluded from the calculation of diluted earnings per share because their effect would have been antidilutive.

5. DERIVATIVE FINANCIAL INSTRUMENTS

During the quarter ended March 31, 2003, current derivative assets increased \$3.8 million and long-term derivative assets decreased \$1.9 million, while current derivative liabilities decreased \$2.3 million and long-term derivative liabilities decreased \$1.6 million. These changes were due primarily to the increased value of two of our 2003 basis swaps and a decrease in the forward strip prices on certain oil contracts offset by an increase in the forward strip prices on all of our gas contracts. Also, during the quarter we recorded a \$1.3 million derivative fair value gain, which was primarily due to changes in the forward LIBOR curve which caused the fair value of our interest rate swaps to increase. As our interest rate swaps do not qualify for hedge accounting, they are marked to market through 'Derivative fair value gain' on the consolidated statement of operations.

For the quarter ended March 31, 2003, we had total comprehensive income of \$19.1 million, while net income totaled \$18.0 million. The difference between net income and total comprehensive income is due to a \$1.1 million decrease in our deferred hedging loss in 'Accumulated Other Comprehensive Income' from \$6.6 million at December 31, 2002 to \$5.5 million at March 31, 2003. For the quarter ended March 31, 2002, we had a total comprehensive loss of \$0.7 million, while net income totaled \$7.1 million. The difference between net income and total comprehensive income is due to a \$7.8 million decrease in deferred hedging gain/loss.

The following tables summarize our open commodity hedging positions as of March 31, 2003:

OIL HEDGES AT MARCH 31, 2003

| PERIOD | DAILY FLOOR VOLUME (BBL) | FLOOR PRICE (PER BBL) | DAILY CAP VOLUME (BBL) | CAP PRICE (PER BBL) | DAILY SWAP VOLUME (BBL) | SWAP PRICE (PER BBL) |
|-----------------|--------------------------------|-----------------------------|------------------------------|---------------------------|-------------------------------|----------------------------|
| ----- | ----- | ----- | ----- | ----- | ----- | ----- |
| Apr - June 2003 | 12,000 | \$ 21.25 | 7,500 | \$ 26.93 | 1,000 | \$ 24.50 |
| July - Dec 2003 | 9,500 | \$ 21.05 | 7,000 | \$ 27.14 | -- | \$ -- |
| Jan - June 2004 | 4,500 | \$ 21.00 | 4,500 | \$ 27.94 | -- | \$ -- |
| July - Dec 2004 | 500 | \$ 21.00 | 500 | \$ 26.00 | -- | \$ -- |

In addition to the amounts noted in the table above, as of March 31, 2003, we had one short oil put contract in place covering 500 Bbls per day at a strike price of \$17.00 which does not qualify for hedge accounting. Accordingly, this

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contract is marked to market through earnings each period. We also have several basis swaps outstanding. The following table summarizes our open basis swap positions:

| PERIOD ----- | DAILY VOLUME (BBLs) ----- | ENCORE PAYS ----- | ENCORE RECEIVES ----- |
|-----------------|---------------------------------|----------------------|--------------------------|
| Apr - Dec 2003 | 3,000 | Platts WTS + \$1.87 | NYMEX WTI |
| Apr - June 2003 | 3,000 | P-Plus | \$4.76 |
| May 2003 | 1,000 | P-Plus | \$4.91 |
| Apr - Dec 2003 | 2,000 | Platts Mars | Platts WTI - \$3.95 |
| May - Dec 2003 | 1,000 | Platts Mars | Platts WTI - \$4.03 |

NATURAL GAS HEDGES AT MARCH 31, 2003

| PERIOD ----- | DAILY FLOOR VOLUME (MCF) ----- | FLOOR PRICE (PER MCF) ----- | DAILY CAP VOLUME (MCF) ----- | CAP PRICE (PER MCF) ----- | DAILY SWAP VOLUME (MCF) ----- | SWAP PRICE (PER MCF) ----- |
|-----------------|---|--------------------------------------|---------------------------------------|------------------------------------|--|-------------------------------------|
| Jan - Dec 2003 | 7,500 | \$ 3.17 | 2,500 | \$ 6.83 | 2,500 | \$ 3.69 |
| Apr - Dec 2004 | 5,000 | \$ 3.25 | 5,000 | \$ 6.10 | -- | \$ -- |

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The actual gains or losses we realize from our hedge transactions may vary significantly from the amounts recorded in the March 31, 2003 balance sheet due to fluctuation of prices in the commodities markets and/or fluctuations in the floating LIBOR interest rate.

INTEREST RATE DERIVATIVES

In conjunction with the sale of its \$150 million 8 3/8% Senior Subordinated Notes ("Notes") on June 25, 2002, the Company repaid all amounts outstanding under its previous credit facility on June 25, 2002, and terminated the facility on that date. At the time, the Company had three interest rate swaps outstanding, with a notional amount of \$30 million each, which swapped LIBOR based floating rates for fixed rates. According to the provisions of SFAS 133, these no longer qualified for hedge accounting. The unrealized loss of \$3.8 million through June 25, 2002, which was recognized in accumulated other comprehensive income, is being amortized to interest expense over the original life of the swaps. We increased interest expense by \$654,000 in the first quarter of 2003 related to the amortization of this unrealized loss.

At the end of 2002, the Company had outstanding two of the interest rate swap contracts with a notional amount of \$30 million each whereby we paid a fixed rate and received LIBOR and one interest rate swap contract whereby we pay LIBOR + 3.89% and receive 8.375% on a \$80 million notional amount. During January 2003, we cash settled the two \$30 million floating for fixed swap contracts at a cost of \$4.3 million. This resulted in a gain of \$647,000 recorded in 'Derivative fair value gain' on the consolidated statement of operations. The following table summarizes the Company's only remaining interest rate swap contract at March 31, 2003:

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| REMAINING TERM | NOTIONAL AMOUNT | ENCORE PAYS | ENCORE RECEIVES |
|----------------------|-----------------|---------------|-----------------|
| Apr 2003 - June 2005 | \$80,000,000 | LIBOR + 3.89% | 8.375% |

6. ENRON SETTLEMENT

On December 2, 2001, Enron Corp. and certain subsidiaries, including Enron North America Corp. ("Enron"), each filed voluntary petitions for relief under Chapter 11 of Title 11 of the United States Bankruptcy Code. Prior to this date, the Company had entered into oil and natural gas hedging contracts with Enron, which were terminated as of December 12, 2001. According to the terms of the contract, Enron was then liable to the Company for the mark-to-market value of all contracts outstanding on that date, which totaled \$6.6 million. Additionally, Enron failed to make timely payment of \$0.4 million in 2001 hedge settlements. Due to the uncertainty of future collection of any or all of the amounts owed to us by Enron, the Company fully reserved this receivable at December 31, 2001. During the first quarter of 2003, due to continued uncertainty of any ultimate collection and continuing legal fees, the Company sold its entire Enron receivable to a third party for \$490,000. As the receivable was fully reserved, this amount was recorded as a gain in the first quarter 2003 and included in 'Other operating' in the consolidated statement of operations. The Company no longer has any claims outstanding with Enron and accordingly has eliminated its previously recorded \$7 million receivable and related allowance for doubtful accounts from the accompanying consolidated balance sheet.

7. FINANCIAL STATEMENTS OF SUBSIDIARY GUARANTORS

All of the Company's subsidiaries are currently subsidiary guarantors of the Notes. Since (i) each subsidiary guarantor is 100% owned by the Company, (ii) the Company has no assets or operations that are independent of its subsidiaries, (iii) the subsidiary guarantees are full and unconditional and joint and several and (iv) all of the Company's subsidiaries are subsidiary guarantors, the Company has not included the financial statements of each subsidiary in this report. The subsidiary guarantors may without restriction transfer funds to the Company in the form of cash dividends, loans and advances.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This document contains forward-looking statements that involve risks and uncertainties that are made pursuant to the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995. Actual results may differ materially from those anticipated in our forward-looking statements due to many factors, including, but not limited to, those set forth under "SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS" contained in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, in Encore's 2002 Annual Report filed on Form 10-K. The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included in this document and Encore's 2002 Form 10-K.

DESCRIPTION OF CRITICAL ACCOUNTING POLICIES

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The information included in "Management's Discussion and Analysis of Financial Condition and Results of Operations - Description of Critical Accounting Policies" in Encore's 2002 Annual Report filed on Form 10-K is incorporated herein by reference. There have been no material changes to our accounting policies during the current quarter with the exception of the adoption of SFAS 143 discussed in Note 3 to the accompanying financial statements.

RESULTS OF OPERATIONS

The following table sets forth operating information of Encore for the periods presented:

| | THREE MONTHS ENDED MARCH 31, | | INCREASE (DECREASE) |
|---|---------------------------------|-----------|------------------------|
| | 2003 | 2002 | |
| Operating Results (in thousands): | | | |
| Oil and natural gas revenues..... | \$ 55,787 | \$ 32,297 | \$ 23,490 |
| Lease operations..... | 8,953 | 6,817 | 2,136 |
| Production, ad valorem and severance taxes.... | 6,169 | 3,013 | 3,156 |
| Daily production: | | | |
| Oil volumes (Bbls)..... | 18,509 | 15,500 | 3,009 |
| Natural gas volumes (Mcf)..... | 21,475 | 23,967 | (2,492) |
| Combined volumes (BOE)..... | 22,088 | 19,494 | 2,594 |
| Average prices (net of hedging): | | | |
| Oil (per Bbl)..... | \$ 27.87 | \$ 19.13 | \$ 8.74 |
| Natural gas (per Mcf)..... | 4.84 | 2.60 | 2.24 |
| Combined volumes (per BOE)..... | 28.06 | 18.41 | 9.65 |
| Average costs (per BOE): | | | |
| Lease operations..... | \$ 4.50 | \$ 3.89 | \$ 0.61 |
| Production, ad valorem and severance taxes.... | 3.10 | 1.72 | 1.38 |
| G&A (excluding non-cash stock based compensation)..... | 1.23 | 0.85 | 0.38 |
| DD&A..... | 3.92 | 4.88 | (0.96) |

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COMPARISON OF QUARTER ENDED MARCH 31, 2003 TO QUARTER ENDED MARCH 31, 2002

Set forth below is our comparison of operations during the first quarter of 2003 with the first quarter of 2002.

REVENUES AND PRODUCTION. Oil and natural gas revenues of Encore for the first quarter of 2003 increased as compared to 2002 by \$23.5 million, from \$32.3 million to \$55.8 million. The following table illustrates the primary components of oil and natural gas revenue for the quarters ended March 31, 2003 and 2002, as well as each quarter's respective oil and natural gas volumes (in thousands, except per unit amounts):

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| | THREE MONTHS ENDED MARCH 31, | | | | DIFFERENCE | |
|---------------------------|------------------------------|------------------|------------|------------------|------------|------------------|
| | 2003 | | 2002 | | | |
| REVENUES: | Revenue | \$/Unit | Revenue | \$/Unit | Revenue | \$/Unit |
| Oil wellhead..... | \$ 52,214 | \$ 31.34 | \$ 26,215 | \$ 18.79 | \$ 25,999 | \$ 12.00 |
| Oil hedges..... | (5,882) | (3.53) | (235) | (0.17) | (5,647) | (3.00) |
| Enron hedges..... | 100 | 0.06 | 706 | 0.51 | (606) | (0.00) |
| Total Oil Revenues... | \$ 46,432 | \$ 27.87 | \$ 26,686 | \$ 19.13 | \$ 19,746 | \$ 8.00 |
| Natural gas wellhead..... | \$ 10,312 | \$ 5.34 | \$ 4,761 | \$ 2.21 | \$ 5,551 | \$ 3.00 |
| Gas hedges..... | (962) | (0.50) | 452 | 0.21 | (1,414) | (0.00) |
| Enron hedges..... | 5 | -- | 398 | 0.18 | (393) | (0.00) |
| Total Gas Revenues... | \$ 9,355 | \$ 4.84 | \$ 5,611 | \$ 2.60 | \$ 3,744 | \$ 2.00 |
| OTHER DATA: | Production | NYMEX \$/Unit | Production | NYMEX \$/Unit | Production | NYMEX \$/Unit |
| Oil (Bbls)..... | 1,666 | \$ 33.86 | 1,395 | \$ 21.64 | 271 | \$ 12.00 |
| Gas (Mcf)..... | 1,933 | 5.91 | 2,157 | 2.49 | (224) | 3.00 |

Total oil revenues increased \$19.7 million from the first quarter of 2002 to the first quarter of 2003. This is primarily due to the 67% increase in wellhead price received over the same period last year. This increase follows general market conditions during which the average NYMEX price increased from \$21.64 to \$33.86 per barrel. Oil volumes also increased, from 1,395 MBbls in the first three months of 2002 to 1,666 MBbls for the same period of 2003. This was the result of the Company's successful development drilling program and the Paradox Basin acquisition completed in the third quarter of 2002. The increase in wellhead oil revenues was partially offset by an increase in payments made for hedging, which increased \$5.6 million. The increase in hedging payments resulted from the increase in the average NYMEX price for oil.

Natural gas revenues increased \$3.7 million due to a \$3.13 per Mcf increase in the wellhead price received, which was partially offset by a 224 MMcf decrease in production, as well as net hedging payments in the first quarter of 2003 versus net hedging receipts in the first quarter of 2002. The wellhead price increase is consistent with overall market conditions, which are reflected in an increase in the NYMEX price from \$2.49 to \$5.91 per Mcf over the same period last year. The decrease in production is due to natural decline in our Crockett County properties. The \$1.4 million unfavorable change in hedge settlements is a result of the increase in gas prices from the first quarter of 2002 to the first quarter of 2003.

LEASE OPERATIONS. Encore's lease operations expense for the first quarter of 2003 increased as compared to the first quarter of 2002 by \$2.1 million. The increase in lease operations expense is primarily attributable to increased production in 2003 and increased expense per BOE. On a per BOE basis, lease operations expense increased from \$3.89 to \$4.50 due to production from the Paradox Basin properties, which have higher per BOE operating costs than the Company's historical average per BOE lease operations expense, as well as higher electricity costs on our Permian and CCA properties. This increase was lower than expected, however, due to higher production volumes and a reduced level of maintenance in the CCA.

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PRODUCTION, AD VALOREM, AND SEVERANCE TAXES. Production, ad valorem, and severance taxes for the first quarter of 2003 increased as compared to the first quarter of 2002 by approximately \$3.2 million, from \$3.0 million to \$6.2 million. The increase in production, ad valorem, and severance taxes was a result of the substantially higher commodity prices in the first quarter of 2003 as compared to the first quarter of 2002. As a percent of oil and natural gas revenues (excluding the effects of hedges), production, ad valorem and severance taxes increased slightly, up to 9.9% from 9.7% in the first quarter of 2002. The effect of hedges are excluded from oil and natural gas revenues in the calculation of the previous percentages because this more closely reflects the method used to calculate actual production, ad valorem, and severance taxes paid to taxing authorities.

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DEPLETION, DEPRECIATION, AND AMORTIZATION (DD&A) EXPENSE. DD&A expense for the first quarter of 2003 decreased by \$0.8 million as compared to the first quarter of 2002, reflecting a decrease in our DD&A rate. The DD&A rate in the first quarter of 2003 of \$3.92 per BOE represents a decrease of \$0.96 per BOE from the \$4.88 per BOE recorded in the first quarter of 2002. The decrease is a result of an increase in reserves and the adoption of SFAS 143 on January 1, 2003 (see Note 3). Historically, consistent with industry practice, the Company assumed salvage value would be offset by plugging and abandonment expenses. However, upon the adoption of SFAS 143, the Company began subtracting the estimated salvage value of its equipment from its depreciable base in its DD&A calculation, thus lowering its per BOE rate.

GENERAL AND ADMINISTRATIVE (G&A) EXPENSE. G&A expense increased \$1.0 million in the first quarter of 2003 as compared to the first quarter of 2002, from \$1.5 million to \$2.5 million (excluding non-cash stock based compensation of \$0.1 million in the first quarter of 2003). The rise in G&A was a result of increased staffing levels and non-recurring consulting services. On a per BOE basis, G&A increased to \$1.23 in the first quarter of 2003 from \$0.85 during the first quarter of 2002.

INTEREST EXPENSE. Interest expense for the quarter ended March 31, 2003 was \$4.2 million compared to \$1.5 million for the quarter ended March 31, 2002. The increase in interest expense is due to higher debt levels, a higher interest rate on our Notes as compared to our previous credit facility, and higher expense due to hedges. Interest expense related to hedges for the three months ended March 31, 2003 reflected in the table below represents the amortization of a mark-to-market loss on our interest rate hedges recorded in conjunction with the issuance of the Notes in the second quarter of 2002 (See Note 5). The weighted average interest rate, including hedges, for the first quarter of 2003 was 10.2% compared to 4.7% for the first quarter of 2002.

| (IN THOUSANDS) | THREE MONTHS ENDED MARCH 31, | | |
|-----------------------------|------------------------------|----------|------------|
| | 2003 | 2002 | DIFFERENCE |
| | ---- | ---- | ----- |
| Credit facility..... | \$ 102 | \$ 985 | \$ (883) |
| 8 3/8% notes due 2012..... | 3,141 | -- | 3,141 |
| Interest rate hedges..... | 654 | 458 | 196 |
| Banking fees and other..... | 274 | 49 | 225 |
| | ----- | ----- | ----- |
| Total..... | \$ 4,171 | \$ 1,492 | \$ 2,679 |
| | ===== | ===== | ===== |

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LIQUIDITY AND CAPITAL RESOURCES

Principal uses of capital have been for the acquisition and development of oil and natural gas properties.

Cash Flow

During the quarter ended March 31, 2003, net cash provided by operations was \$25.7 million, an increase of \$8.5 million compared to the quarter ended March 31, 2002. This increase is a result of higher oil and natural gas prices and higher oil production. Cash used by investing activities decreased from \$71.1 million to \$23.1 million over the same period, primarily due to the Central Permian acquisition in the first quarter of 2002 with no similar acquisition in the first quarter of 2003. Cash used by financing activities was \$7.3 million in the first three months of 2003, as compared to cash provided by financing activities of \$53.9 million in the first three months of 2002. The decrease is primarily attributable to borrowings used to fund the Central Permian acquisition in 2002, while high commodity prices allowed us to repay \$8.0 million under our credit facility during the first quarter of 2003.

Capitalization

At March 31, 2003, Encore had total assets of \$572.9 million. Total capitalization was \$474.3 million, of which 66.7% was represented by stockholders' equity and 33.3% by debt. The following table details the components of the Company's total capitalization at March 31, 2003 (in thousands):

| | MARCH 31, 2003 ----- |
|---------------------------------|----------------------------|
| Long-term debt..... | \$ 158,000 |
| Total stockholder's equity..... | 316,259 |
| | ----- |
| Total capitalization..... | \$ 474,259 ===== |

Debt Maturities

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Of our \$158.0 million debt balance at March 31, 2003, \$150.0 represents our Notes maturing on June 15, 2012. The remaining \$8.0 million is outstanding under our revolving credit facility, from which the total amount available to us is \$220.0. The maturity date of the facility is June 25, 2006.

Future Capital Requirements

In April 2003, the Board of Directors approved an increase to Encore's 2003 capital budget in the amount of \$20.0 million to begin the second phase of the high-pressure air injection ("HPAI") tertiary recovery project in the CCA. This, when added to the previously announced \$105.0 million capital budget, will give the Company a capital budget of \$125.0 million for 2003.

We anticipate that our capital expenditures will total approximately \$30.0

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million for the second quarter of 2003. The level of these and other future expenditures and the amount of funds devoted to any particular activity may increase or decrease significantly, depending on available opportunities and market conditions. We plan to finance our ongoing development and acquisition expenditures using internally generated cash flow, available cash, and our existing credit facility.

The Company believes that its capital resources from internally generated cash flows and funds available under the credit facility are adequate to meet the requirements of its business through 2004. Based on our anticipated capital investment programs, we expect to invest our internally generated cash flow to replace production volumes and enhance our waterflood programs. Additional capital may be required to pursue acquisitions and longer-term capital projects, such as our HPAI program, to increase our reserve base. Substantially all of these expenditures are discretionary and will be undertaken only if funds are available and the projected rates of return are satisfactory. Future cash flows are subject to a number of variables, including the level of oil and natural gas production volumes and prices. Operations and other capital resources may not provide cash in sufficient amounts to maintain planned levels of capital expenditures.

The following table illustrates the Company's contractual obligations outstanding at March 31, 2003 (in thousands):

| CONTRACTUAL OBLIGATIONS | TOTAL | PAYMENTS DUE BY PERIOD | | | THEREAFTER |
|-----------------------------|------------|------------------------|-------------|-------------|------------|
| | | 2003 | 2004 - 2005 | 2006 - 2007 | |
| 8 3/8% Notes..... | \$ 150,000 | \$ -- | \$ -- | \$ -- | \$ 150,000 |
| Revolving Credit Facility.. | 8,000 | -- | -- | 8,000 | -- |
| Operating Leases..... | 3,561 | 719 | 1,938 | 691 | 213 |
| Totals..... | \$ 161,561 | \$ 719 | \$ 1,938 | \$ 8,691 | \$ 150,213 |

INFLATION AND CHANGES IN PRICES

While the general level of inflation affects certain of our costs, factors unique to the petroleum industry result in independent price fluctuations. Historically, significant fluctuations have occurred in oil and natural gas prices. In addition, changing prices often cause costs of equipment and supplies to vary as industry activity levels increase and decrease to reflect perceptions of future price levels. Although it is difficult to estimate future prices of oil and natural gas, price fluctuations have had, and will continue to have, a material effect on us.

The following table indicates the average oil and natural gas prices received for the quarter ended March 31, 2003 and 2002. Average equivalent prices for 2003 and 2002 were decreased by \$3.39 and increased by \$0.75 per BOE, respectively, as a result of our hedging activities (including amortization of the gain on our discontinued Enron hedges). Average prices per equivalent barrel indicate the composite impact of changes in oil and natural gas prices. Natural gas production is converted to oil equivalents at the conversion rate of six Mcf per Bbl.

| OIL (PER BBL) | NATURAL GAS (PER MCF) | EQUIV. OIL (PER BOE) |
|------------------|--------------------------|-------------------------|
| ----- | ----- | ----- |

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NET PRICE REALIZATION WITH HEDGES

| | | | |
|-----------------------------------|----------|---------|----------|
| Quarter ended March 31, 2003..... | \$ 27.87 | \$ 4.84 | \$ 28.06 |
| Quarter ended March 31, 2002..... | 19.13 | 2.60 | 18.40 |

NET PRICE REALIZATION WITHOUT HEDGES

| | | | |
|-----------------------------------|----------|---------|----------|
| Quarter ended March 31, 2003..... | \$ 31.34 | \$ 5.34 | \$ 31.45 |
| Quarter ended March 31, 2002..... | 18.79 | 2.21 | 17.65 |

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information included in "Quantitative and Qualitative Disclosures About Market Risk" in Encore's 2002 Annual Report filed on Form 10-K is incorporated herein by reference. Such information includes a description of Encore's potential exposure to market risks, including commodity price risk and interest rate risk. Encore's open commodity positions as of March 31, 2003 are presented in Note 5 to the accompanying financial statements. The fair value of our open commodity and interest rate hedges is (\$0.5) million as of March 31, 2003.

Subsequent to the first quarter of 2003, we entered into additional oil hedges. Through May 2, 2003, we entered into floors covering 2,000 Bbls per day at an average strike price of \$21.75 for the first six months of 2004.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of disclosure controls and procedures. Within 90 days prior to the filing date of this Report, the Company's principal executive officer ("CEO") and principal financial officer ("CFO") carried out an evaluation of the effectiveness of the Company's disclosure controls and procedures. Based on those evaluations, the Company's CEO and CFO believe (i) that the Company's disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports it files under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to the Company's management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure; and (ii) that the Company's disclosure controls and procedures are effective.

(b) Changes in internal controls. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect the Company's internal controls subsequent to the evaluation referred to in Item 4. (a), above, nor have there been any corrective actions with regard to significant deficiencies or material weaknesses.

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PART II. OTHER INFORMATION

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

Exhibits

- 3.1 Second Amended and Restated Certificate of Incorporation of the Company (incorporated by reference to the Company's Quarterly

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Report on Form 10-Q for the fiscal quarter ended September 30, 2001, filed with the SEC on November 7, 2001).

- 3.2 Second Amended and Restated Bylaws of the Company (incorporated by reference to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2001, filed with the SEC on November 7, 2001).
- **10.1 Employee Severance Protection Plan
- **10.2 Form of Restricted Stock Award - Executive
- 99.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- ** Management compensatory plan or contract

Reports on Form 8-K

During the three months ended March 31, 2003, the Company filed with the SEC current reports on Form 8-K on February 3, February 13, and March 27.

The Company's February 3, 2003 Form 8-K included as an exhibit a press release announcing year end 2002 reserves, production, and finding and development costs.

The Company's February 13, 2003 Form 8-K included as an exhibit a press release announcing full year and fourth quarter 2002 results.

The Company's March 27, 2003 Form 8-K filing includes as an exhibit a press release announcing resignation of Gene R. Carlson, Executive Vice President and Chief Operating Officer.

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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 thereunto duly authorized.

ENCORE ACQUISITION COMPANY

Date: May 7, 2003

By: /s/ Morris B. Smith

Morris B. Smith
Chief Financial Officer, Treasurer,
Executive Vice President,
Secretary and Principal Financial Officer

Date: May 7, 2003

By: /s/ Robert C. Reeves

Robert C. Reeves
Vice President, Controller and Principal
Accounting Officer

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CERTIFICATIONS

I, I. Jon Brumley, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Encore Acquisition Company:

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 7, 2003

By: /s/ I. Jon Brumley

I. Jon Brumley
Chairman and Chief Executive Officer

I, Morris B. Smith, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Encore Acquisition Company:

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 7, 2003

By: /s/ Morris B. Smith

Morris B. Smith
Chief Financial Officer, Treasurer,
Executive Vice President and Secretary

INDEX TO EXHIBITS

| EXHIBIT NO. | DESCRIPTION |
|-------------|---|
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