PETROHAWK ENERGY CORP
Form 10-K/A
June 04, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A

(Amendment No. 2)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

Commission file number 000-25717

PETROHAWK ENERGY CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**86-0876964**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

1000 Louisiana, Suite 5600, Houston, Texas 77002

(Address of principal executive offices including ZIP code)

(832) 204-2700

(Registrant s telephone number)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value $.001 per share	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

Large accelerated filer x 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 x

The aggregate market value of Common Stock, par value $.001 per share (Common Stock), held by non-affiliates (based upon the closing sales price on the NASDAQ Global Select Market on June 30, 2006), the last business day of registrant s most recently completed second fiscal quarter was approximately $973 million.

As of February 23, 2007, there were 168,536,049 shares of Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None

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EXPLANATORY NOTE

Petrohawk Energy Corporation (hereinafter referred to as Petrohawk, the Company, we, us, or our) is filing this Amendment No. 2 on Form 10-K/A (this Amendment No. 2) to its Annual Report on Form 10-K for the fiscal year ended December 31, 2006, originally filed with the Securities and Exchange Commission (SEC) on February 28, 2007 (the Original Report).

The purpose of this Amendment is to amend Item 1. *Business* and Item 7. *Management s discussion and analysis of financial condition and results of operations* to include the following additional disclosures (1) reserve and production information for our principal fields within the *Core Operating Regions* section of Item 1. *Business* and (2) additional pricing and production information for natural gas liquids in Item 1. *Business* and Item 7. *Management s discussion and analysis of financial condition and results of operations* in response to comments from the SEC following their review of the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2006. Further, we have amended Item 8. *Consolidated financial statements and supplementary data* to correct information reported in the Supplemental Oil and Gas Information disclosure. This amended item restates the following tables:

Costs Incurred in Oil and Natural Gas Property Acquisition, Exploration and Development Activities table;

Standardized Measure of Discounted Future Net Cash Flows Relating to Proved Oil and Natural Gas Reserves table; and

Changes in Standardized Measure of Discounted Future Net Cash Flows Relating to Proved Oil and Natural Gas Reserves table.

The Costs Incurred in Oil and Natural Gas Property Acquisition, Exploration and Development Activities table has been restated to combine asset retirement costs with Property acquisition costs, proved and Development costs.

The Standardized Measure of Discounted Future Net Cash Flows Relating to Proved Oil and Natural Gas Reserves table has been restated to correct the amount of future income tax expense recognized and correct the methodology utilized in the discount calculation including consideration of the annual impact of income taxes in future periods.

The Changes in Standardized Measure of Discounted Future Net Cash Flows Relating to Proved Oil and Natural Gas Reserves table has been restated to correct Changes in income taxes, net and add Development costs incurred in addition to line items miscalculated in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006, originally filed on February 28, 2007.

This amendment does not affect the Company s historical results of operations, financial conditions, cash flows, reserves or production for any periods presented. While we are amending only certain portions of Items 1, 7 and 8 of our Form 10-K, for convenience and ease of reference, we are filing the entire text of Parts I and II of Form 10-K. In addition, in accordance with applicable rules promulgated by the SEC, we have included currently dated certifications from our Chief Executive Officer and Chief Financial Officer and currently dated consents from named experts other than as specified above. This Amendment No. 2 does not reflect events occurring after the filing of the original Annual Report or modify or update those disclosures affected by subsequent events. Accordingly, this Amendment No. 2 should be read in conjunction with our filings made with the Securities and Exchange Commission.

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Special note regarding forward-looking statements

This report on Form 10-K contains forward-looking statements within the meaning of the federal securities laws. These forward-looking statements may include, among others, statements reflecting the following:

- our growth strategies;
- anticipated trends in our business;
- our future results of operations;
- our ability to make or integrate acquisitions;
- our liquidity and ability to finance our exploration, acquisition and development activities;
- our ability to successfully and economically explore for and develop oil and natural gas resources;
- market conditions in the oil and natural gas industry;
- the impact of government regulation;
- planned capital expenditures;
- increases in oil and natural gas production;
- our financial position, business strategy and other plans and objectives for future operations;
- reserve and production estimates;
- future financial performance; and
- other matters that are discussed in our filings with the United States Securities and Exchange Commission (SEC).

We identify forward-looking statements by use of terms such as expect, anticipate, estimate, plan, believe, intend, will, continue, p should, could and similar words and expressions, although some forward-looking statements may be expressed differently. You should be aware that our actual results could differ materially from those contained in the forward-looking statements. You should consider carefully the statements under the Risk Factors section of this report and other sections of this report which describe factors that could cause our actual results to differ from those set forth in the forward-looking statements, and the following factors:

the possibility that the industry may be subject to future regulatory or legislative actions (including any additional taxes);

the volatility in commodity prices, supply of, and demand for, oil and natural gas;

risks associated with derivative positions;

the difficulty of estimating the presence or recoverability of oil and natural gas reserves and the future production rates and associated costs;

the need for us to continually replace oil and natural gas reserves;

environmental risks;

drilling and operating risks and expense cost escalations;

exploration and development risks;

the ability of the our management to execute its plans to meet its goals;

our ability to retain key members of senior management and key employees;

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- general economic conditions, whether internationally, nationally or in the regional and local market areas in which we are doing business, may be less favorable than expected;

- continued hostilities in the Middle East and other sustained military campaigns or acts of terrorism or sabotage; and

- other economic, competitive, governmental, legislative, regulatory, geopolitical and technological factors that may negatively impact our businesses, operations or pricing.

All forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements in this paragraph and elsewhere in this document. Other than as required under the securities laws, we do not assume a duty to update these forward-looking statements, whether as a result of new information, subsequent events or circumstances, changes in expectations or otherwise.

PART I

ITEM 1. BUSINESS

Overview

We are an independent oil and natural gas company engaged in the acquisition, development, production and exploration of oil and natural gas properties located onshore in North America. We were formed in June 1997 as a Nevada corporation and were reincorporated in the state of Delaware in July 2004. Our properties are concentrated in East Texas/North Louisiana, onshore Gulf Coast, and in the Permian, Anadarko and Arkoma basins. We have increased our proved reserves and production through acquisitions and the exploitation of acquired properties. In 2006, we acquired approximately 537 billion cubic feet of natural gas equivalent (Bcfe) proved reserves for approximately $2.2 billion primarily in conjunction with our acquisitions in North Louisiana and our merger with KCS Energy, Inc. (KCS). In addition, we sold an estimated 80 Bcfe of proved reserves for approximately $200 million.

During 2006, excluding acquisitions, we replaced approximately 402% of our production organically. Organic reserve additions were primarily driven by drilling tight sand natural gas wells in North Louisiana and 3-D seismic supported exploration drilling in the onshore Gulf Coast region. Fields that contributed significantly to the additions included Elm Grove/Caspiana (Bossier and Caddo Parishes, Louisiana); Terryville (Lincoln Parish, Louisiana); Lions (Goliad County, Texas); Nabors (Starr County, Texas); Jalmat (Lea County, New Mexico) and W.E. Colson (Brooks County, Texas). Following the acquisition of KCS in July 2006, we focused on an active drilling program. We participated in the drilling of 330 and 146 wells in 2006 and 2005, of which 20 and nine were dry holes, for a success rate of 94% in 2006 and 2005.

At December 31, 2006, our estimated total proved oil and natural gas reserves were approximately 1,076 Bcfe, consisting of 31 million barrels of oil (MMBbl) of oil, condensate and natural gas liquids, and 889 billion cubic feet (Bcf) of natural gas. Approximately 63% of our proved reserves were classified as proved developed.

We focus on maintaining a balanced, geographically diverse portfolio of long-lived, lower risk reserves along with shorter lived, higher margin reserves. We believe that this balanced reserve mix provides a diversified cash flow foundation to fund our development and exploration drilling program. We believe the steps taken during 2006, along with our multi-year drilling prospect inventory, position us to increase production and grow reserves in 2007 and beyond.

Recent Developments

We have recently completed several transactions:

Acquisitions

KCS Energy, Inc.

On April 21, 2006, we announced that we had entered into a definitive agreement to merge with KCS. The merger was consummated on July 12, 2006 and was consistent with our goal of acquiring properties within our core operating areas that have a significant proved reserve component and which we believe have additional development and exploration opportunities.

Upon the closing of the merger, KCS stockholders became entitled to receive a combination of $9.00 cash and 1.65 shares of our common stock for each share of KCS common stock. Total consideration for KCS consisted of approximately $1.1 billion of our common stock, approximately $450 million of cash and the assumption of $275 million of KCS debt. In addition, all outstanding options to purchase KCS common stock and restricted shares of KCS common stock were converted into options to purchase our common stock or restricted shares of our common stock using an exchange ratio of approximately 2.3706 shares of our common stock to one share of KCS common stock.

In conjunction with our merger with KCS, we consummated a private placement of $650 million of 9 $^{1}/8$% senior notes which we applied a portion of the net proceeds to fund the cash paid by us to the KCS stockholders.

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In addition, we amended our senior revolving credit facility agreement and we repaid our second lien term loan facility. See the section entitled *Contractual Obligations* under Item 7. *Management s Discussion and Analysis of Financial Condition and Results of Operations* for more details.

The North Louisiana Acquisitions

On January 27, 2006, we completed the acquisition of all of the issued and outstanding common stock of Winwell Resources, Inc. (Winwell). Total consideration for Winwell was approximately $208 million in cash after certain closing adjustments. Also on January 27, 2006, we completed an acquisition of assets from Redley Company (Redley). Total consideration for the assets was approximately $86 million in cash after certain closing adjustments. In the Winwell and Redley transactions (referred to as the North Louisiana Acquisitions), we acquired natural gas properties in the Elm Grove and Caspiana fields in North Louisiana.

Divestitures

Michigan, Wyoming and California

During the fourth quarter of 2006 we sold certain of our oil and natural gas assets in Michigan, Wyoming and California with total estimated proved reserves of approximately 49 Bcfe. The majority of these assets were acquired in our merger with KCS. Our proceeds from these three separate transactions were approximately $135 million, before adjustments, and were recorded as a decrease to our full cost pool.

Gulf of Mexico

On March 21, 2006, we completed the sale of substantially all of our Gulf of Mexico properties for $52.5 million ($43.2 million after certain closing adjustments). These proceeds were recorded as a decrease to our full cost pool.

Business Strategy

Our primary objective is to increase stockholder value. To accomplish this objective, our business strategy is focused on the following:

Pursuit of Strategic Acquisitions. We continually review opportunities to acquire properties, leasehold acreage and drilling prospects that are complementary to our existing properties. We seek negotiated transactions to acquire operational control of properties that we believe have significant exploitation and exploration potential. Our strategy includes a significant focus on increasing our holdings in fields and basins in which we already own an interest.

Exploitation of Existing Properties. We have a significant inventory of future drilling locations in targeted areas. Generally, these locations range in depth from 5,000 feet to 13,000 feet and we believe offer relatively low risk opportunities to add production and proved reserves. Most of the locations are step-out or extension wells from existing production in resource plays. We also seek to add proved reserves and increase production through the use of advanced technologies, including detailed reservoir engineering analysis, drilling infill and extension wells utilizing sophisticated fracture stimulation techniques and selectively recompleting existing wells. We believe that many of the properties we have acquired have significant potential and in certain cases have not been actively developed in the past.

Growth Through Exploration. We conduct an active technology-driven exploration program, primarily in the onshore Gulf Coast region, that is designed to complement our property acquisition and development drilling activities with moderate to high risk exploration projects that may have greater reserve potential.

Property Portfolio Management. We continually evaluate our property base to identify opportunities to divest non-core, higher cost or less productive properties with limited development potential. This strategy allows us to focus on a portfolio of core properties with significant potential to increase our proved reserves and production. We also focus on reducing the per unit operating costs associated with our existing properties as evidenced by our lease operating expense reduction from $1.04 per Mcfe in 2005 to $0.73 per Mcfe in 2006.

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Maintenance of Financial Flexibility. We intend to maintain substantial borrowing capacity under our senior revolving credit facility. We believe our internally generated cash flows, our borrowing capacity and access to the capital markets will provide us with the financial flexibility to pursue additional acquisitions of producing properties and leasehold acreage and to execute our drilling program. Another component of our financial management strategy includes the use of hedges to secure product prices for a substantial portion of our expected production.

Benefit from the Transactional Nature of Our Industry. The independent exploration and production industry has been consolidating for a number of years. Our business strategy embraces this trend. We intend to assemble a portfolio of quality proved reserves and drilling opportunities within a core group of operated properties that may potentially be desirable as a strategic acquisition target by larger industry participants.

Oil and Natural Gas Reserves

The December 31, 2006 proved reserve estimates presented in this document were prepared by Netherland, Sewell and Associates, Inc. (Netherland, Sewell). For additional information regarding estimates of proved reserves, the preparation of such estimates by Netherland, Sewell and other information about our oil and natural gas reserves, see Item 8. *Consolidated Financial Statements and Supplementary Data Supplemental Oil and Gas Information*. Our reserves are sensitive to commodity prices and their effect on economic producing rates.

The reserves information in this Form 10-K represents only estimates. There are a number of uncertainties inherent in estimating quantities of proved reserves, including many factors beyond our control, such as commodity pricing. Reserve engineering is a subjective process of estimating underground accumulations of oil and natural gas that cannot be measured in an exact manner. The accuracy of any reserve estimate is a function of the quality of available data and of engineering and geological interpretation and judgment. As a result, estimates of different engineers may vary. In addition, results of drilling, testing and production subsequent to the date of an estimate may justify revising the original estimate. Accordingly, initial reserve estimates are often different from the quantities of oil and natural gas that are ultimately recovered. The meaningfulness of such estimates depends primarily on the accuracy of the assumptions upon which they were based. Except to the extent we acquire additional properties containing proved reserves or conduct successful exploration and development activities or both, our proved reserves will decline as reserves are produced.

The following table presents certain information as of December 31, 2006. Oil and natural gas liquids are based on the December 31, 2006 West Texas Intermediate posted price of $57.75 per barrel and are adjusted by lease for quality, transportation fees, and regional price differentials. Gas prices are based on a December 31, 2006 Henry Hub spot market price of $5.63 per MMBtu and are adjusted by lease for energy content, transportation fees, and regional price differentials. All prices are held constant in accordance with SEC guidelines. Shut-in wells currently not capable of production are excluded from the producing well information.

	Mid-Continent	Gulf Coast(2)	Permian Basin(3)	Total
Proved Reserves at Year End (Bcfe)				
Developed	358.9	153.1	161.7	673.7
Undeveloped	303.8	51.0	47.6	402.4
Total	662.7	204.1	209.3	1,076.1
Gross Wells	2,615	971	2,487	6,073
Net Wells (1)	821.3	451.5	825.0	2,097.8

(1) *Net wells represents our working interest share of each well. The term net as used in net production throughout this document refers to amounts that include only acreage or production that is owned by the Company and produced to its interest, less royalties and production due to others.*

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(2) *Included in the Gulf Coast region is approximately 3.8 Bcfe of proved reserves located in federal waters of the Gulf of Mexico.*
(3) *Included in the Permian region is approximately 1.3 Bcfe of proved reserves located in Utah, North Dakota and South Dakota.*

Core Operating Regions

We provide reserves and production information for our principal producing fields in the following regional disclosures.

Mid-Continent Region

In the Mid-Continent region, we concentrate our drilling programs primarily in North Louisiana, East Texas and the Anadarko and Arkoma basins. Our Mid-Continent region operations provide us with a solid base for production and reserve growth. As of December 31, 2006, approximately 62% of our reserves, or 662.7 Bcfe, were located in our Mid-Continent fields. Our production from these fields averaged approximately 160 MMcfe/d in the second half of 2006. We plan to continue to exploit areas within the various basins that require low-risk exploitation wells for additional reservoir drainage. Our exploitation wells are generally infill and extension type wells. During 2006, we drilled 203 wells in this region with a success rate of 97%. In 2007, we plan to drill approximately 360 wells in this region, over half of which are planned in the Elm Grove/Caspiana and Terryville fields. We will also pursue drilling in horizontal plays in East Texas and North Louisiana, the Fayetteville shale, the Woodford shale and various other fields.

Elm Grove/Caspiana Field Our largest field, located primarily in Bossier and Caddo Parishes of North Louisiana, produces from the Hosston and Cotton Valley formations. These zones are composed of low permeability sandstones that require fracture stimulation treatments to produce. In 2006, we consolidated acreage from two significant acquisitions, increasing our acreage position so that we currently own working interests in 99 sections giving us exposure to 63,360 gross unit acres, over 35,000 gross acres and over 24,000 net acres. A section is approximately 640 acres or one square mile. We also own mineral and royalty interests in another twelve sections giving us exposure to another 7,680 gross unit acres and close to 1,000 net acres. In the second half of 2006, these fields contributed approximately 30% of our overall net production. As of December 31, 2006, proved reserves for the Elm Grove/Caspiana field were approximately 457 Bcfe, of which approximately 50% were classified as proved undeveloped and approximately 20% proved developed non-producing.

We have been actively drilling infill and step-out wells at Elm Grove utilizing between four and six operated drilling rigs. During the year, we drilled 92 wells increasing net production to nearly 100 MMcfe/d at year-end. In 2007, we plan to drill approximately 100 operated wells to continue growing production and reserves. In addition, we anticipate that we will participate in an estimated 35 non-operated wells.

We have also been successful in two production advancement initiatives in the Elm Grove/Caspiana field. The first initiative involves the use of coiled tubing to fracture stimulate and commingle the shallower Hosston formation with the existing Lower Cotton Valley formation, increasing the present value of the wells and eliminating additional capital expenditures. To date we have performed over 90 of these procedures successfully. We have also begun testing the economics of down-spacing the Lower Cotton Valley formation to 20 acre spacing. Our pilot program has now included the successful drilling of 19 20-acre spacing wells. In 2007 we plan to continue both programs.

Terryville Field Located in Lincoln Parish, Louisiana, this is our second largest producing field. We have acquired a very significant acreage position and hold working interests in over 100 sections surrounding the core producing area of the field, with over 60,000 gross unit acres and 34,000 net acres. The objective formations in this field include the Cotton Valley and Gray sands. In 2006 we drilled 17 wells increasing net production to approximately 35 MMcfe/d at year end. As of

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December 31, 2006, proved reserves for this field were approximately 84 Bcfe. For 2007, we plan to drill approximately 50 wells, including several extension and exploration wells.

WEHLU Field The West Edmond Hunton Lime Unit, or WEHLU, covers 30,000 gross unit or 29,000 net acres (approximately 47 square miles) primarily in Oklahoma County, Oklahoma. The WEHLU field, originally discovered in 1942, is the largest Hunton Lime formation field in the state of Oklahoma. The field has 38 oil and natural gas wells (36 currently producing approximately 6 MMcfe/d net) with stable production holding the entire unit. We own a 98% working interest and 80% net revenue interest in the majority of the field. Additionally, we have an agreement with a company to jointly develop additional reserves and production in a portion of WEHLU. The area of mutual interest created by the agreement covers 5,680 acres located in the central northwest portion of the field and we own a 40% working interest and 33% net revenue interest in this area. Six successful horizontal wells were drilled in 2006 and we expect to drill seven additional horizontal wells in WEHLU in 2007. As of December 31, 2006, proved reserves for this field were approximately 18 Bcfe.

Fayetteville Shale We have interest in 51,200 gross unit acres or 10,500 net acres, primarily in Van Buren and Pope Counties. We drilled three operated wells and participated in three non-operated wells in 2006 to begin exploitation of our acreage position. At year-end, all of these wells were awaiting completion or pipelines. In 2007, we intend to expand our drilling effort in this area by drilling at least eight operated wells and we anticipate participation in another 12 non-operated wells.

Woodford Shale We have an interest in approximately 41 sections, or over 26,000 gross acres, in the Woodford Shale trends within the Arkoma and Ardmore Basins. Of these 41 sections, approximately 15 are in the Pine Hollow field area. We have six non-operated approved authorizations for expenditures for wells that we expect to be drilled in 2007, and anticipate additional operations to occur. The other 26 sections are located within several prospect areas where we are actively acquiring acreage and expect to initiate drilling operations during 2007.

East Texas Our properties in the East Texas Basin produce primarily from the Cotton Valley, Travis Peak and James Lime formations, which range in depth from approximately 6,500 feet to 10,000 feet. We own significant interests in the South Carthage, North Beckville and Blocker fields in Panola and Harrison Counties, Texas. Our working interest in these fields is between 47% and 100%. We have been actively acquiring acreage in the developing James Lime horizontal play and in the Travis Peak vertical play in Nacogdoches and Shelby Counties, Texas. To date we have acquired over 21,000 net acres in the trend with a 74% working interest. During 2006 we drilled two horizontal James Lime wells and two vertical Travis Peak wells in this trend, and anticipate drilling additional wells in both of these plays in 2007.

Gulf Coast Region

In the Gulf Coast region, we have oil and natural gas operations in south Texas, south Louisiana and the Mississippi salt dome basin. We are actively developing our properties and exploring on-trend acreage for new fields. In south Texas, where we have our most significant acreage position, we predominately explore Wilcox, Frio and Vicksburg aged formations. Production from the Gulf Coast region averaged 101 MMcfe/d during the second half of 2006. During 2006 we drilled 56 wells in this region with an overall success of 85%. In 2007 we plan to drill approximately 75 wells, particularly concentrating on fields where delineation and development of recent discoveries is warranted.

South Texas

Lions Field The Lions field in Goliad County continues to be a primary operational area for us. We drilled four wells during 2006, three of which have been completed and one is awaiting completion. Two fourth quarter wells, the Weise #3 and Dehnert #2, had initial flow rates in excess of 6 MMcfe/d and 14 MMcfe/d, respectively. The Weise #4, which we expect to have initial sales in the first quarter of 2007, should also be a high rate well. We own approximately 55% working interest in all three wells. We currently have two rigs drilling in the field, one operated and one non-operated, and expect to drill at least six wells during 2007. Additionally, we finalized the acquisition of a high-density 3-D seismic survey in the fourth quarter of 2006 and are utilizing this improved data volume in our 2007 field development program. As of December 31, 2006, proved reserves for the Lions field were approximately 15 Bcfe. Production in the fourth quarter of 2006 averaged 13 Mmcfe/d.

Austin/Mission Rosario Fields We were active in these neighboring field areas in 2006 with the completion of three wells in the Mission Rosario Field and two wells in the Austin Field. In Mission Rosario, we completed the O Connor Ranch #36 (100% working interest), #37 (50% working interest) and #38 (100% working interest), and are currently drilling the #41 (100% working interest). All of these wells are geopressured Lower Wilcox wells that have had initial production of 1.5 MMcfe/d to 4.0 MMcfe/d. In the Austin field, we completed the Dreier #1 (28% working interest) and Salyer- Sherman #1 (58% working interest) from Lower Wilcox sands and had initial rates of 8.5 MMcfe/d and 7.8 MMcfe/d, respectively. We are also in the process of acquiring a new 3-D seismic survey between these two fields that we anticipate will create additional drilling opportunities in 2007.

La Reforma Field We continue to achieve excellent success with the drilling program in this Lower Vicksburg field in Starr County, Texas where we own a 50% working interest. During 2006 we completed the Guerra D #7 at a rate in excess of 9 MMcfe/d, the Guerra D #6 with initial production of 10 MMcfe/d and are currently drilling the Guerra D #9 in a fault block offsetting the Guerra D #7. We also are in the process of completing the Guerra B #1 in Frio sands at approximately 7,500 feet. In 2007, we anticipate drilling between four to seven additional wells in this field. As of December 31, 2006, proved reserves for the La Reforma field were approximately 16 Bcfe. Production in the fourth quarter of 2006 averaged 7 Mmcfe/d.

Provident City Field In 2006 we finalized the completion of the Garrett #1 and #2 wells (50% working interest) in multiple Lower Wilcox sands, with initial rates of 11 MMcfe/d and 2 MMcfe/d, respectively. Additionally, we have developed several more prospects in this area and anticipate drilling at least two wells in 2007.

Nabors Field We completed two wells in 2006 in this field in Starr County, Texas. The Cleopatra #5 and #7, both 100% working interest wells, were completed in Lower Vicksburg sands at initial production rates in excess of 11 MMcfe/d and 9 MMcfe/d, respectively. In 2007 we anticipate drilling at least two additional development wells and at least two additional exploratory wells in the field area.

South Louisiana

Gueydan Field We have multiple opportunities to expand production in this salt dome field in Vermilion Parish, Louisiana where we have 3,000 net acres. We have recently completed acquisition of new 3-D seismic data that was shot specifically to delineate shallow prospects similar to a well that we completed in early 2005. We anticipate drilling at least three shallow exploratory wells in 2007 to test the prospects we have identified with this 3-D data set. We also are in the final stages of performing a Pre-Stack Depth Migration of a large 3-D data set in order to finalize the interpretation of several deep Frio prospects on the flanks of the dome. Once the re-processing of this data has been completed we anticipate drilling an approximate 16,000 foot Camerina test, and have other Mio-Gyp and Marg Tex prospects identified.

Mississippi Salt Dome Basin

Winchester Prospect We have completed two new field discoveries on prospects in Wayne County, Mississippi. The Board of Education #16-11 and the Clark #4-5 were both completed in the fourth quarter of 2006 in the Smackover at approximately 15,500 feet at rates in excess of 900 barrels of oil

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equivalent per day (BOE/d) and 700 BOE/d, respectively. We also have completed drilling the Board of Education #16-14 as an offset to the #16-11 and anticipate completing it in the first quarter of 2007. We will have two rigs operating in the first half of 2007 to accelerate the development of these field areas. Production from this field was deferred until the end of 2006 due to the need to build a gas pipeline, but we expect significant production growth from this region through 2007.

Permian Basin Region

In the Permian Basin region, our principal properties are in the Waddell Ranch field in Crane County, Texas, the TXL field located in Ector County, Texas, the Sawyer Canyon field in Sutton County, Texas and the Jalmat field in Lea County, New Mexico. These legacy fields have low production declines and we pursue low risk workover and development drilling programs designed to replace production. During the second half of 2006, production from this region averaged 41 MMcfe/d. We drilled 52 wells in this region in 2006 with a 92% success ratio. In 2007 we anticipate drilling 50 to 60 wells.

Waddell Ranch Field This field is located in Crane County, Texas and is our most significant property in the region. The Waddell Ranch Field complex is comprised of over 75,000 gross or 22,100 net acres and is productive from over 15 different reservoirs. The primary production is from the Queen, Grayburg, San Andres, Clearfork, and Ellenburger formations ranging in depth from 3,000 feet to 11,000 feet. We have a working interest in this non-operated field that ranges from 18.5% to 75.2%. During 2006, 22 wells were drilled along with 62 workovers and a similar program is planned for 2007. As of December 31, 2006, proved reserves for the Waddell Ranch field were approximately 62 Bcfe. Production in the fourth quarter of 2006 averaged 8 Mmcfe/d. Approximately 75% of the field production is oil.

Sawyer Canyon Field This field is located in Sutton County, Texas and is the second most significant property in the region. The field encompasses approximately 50 sections and during the past several years there have been drilling programs targeting shallow Canyon sandstone formations. We have a 92% to 100% working interest in most of the areas we are actively drilling. We plan to drill six wells in 2007. As of December 31, 2006, proved reserves for the Sawyer Canyon field were approximately 39 Bcfe. Production in the fourth quarter of 2006 averaged 11 Mmcfe/d.

TXL Field This waterflood is located in Ector County, Texas and is unitized in the Clearfork/Tubb formation at approximately 5,600 feet. We have a 20% working interest and a 25% net revenue interest in this non-operated property. Over 100 additional infill drill sites remain to be drilled in this property which we believe will lead to additional proved reserves as well as upside potential. Twelve wells were drilled in 2006 and 14 wells are planned for 2007. As of December 31, 2006, proved reserves for the TXL field were approximately 25 Bcfe. Production in the fourth quarter of 2006 averaged 3 Mmcfe/d. Approximately 63% of the field production is oil.

Jalmat Field An extensive review of Jalmat Field, located in Lea County, New Mexico, has resulted in the identification of over 45 recompletion/stimulation workovers in the Tansill, Yates and Seven Rivers and significant waterflood potential in the Seven Rivers-Queen zone. Offsetting units have had excellent waterflood results in this same interval. We own a 96% working interest and 83% net revenue interest in this field. In 2006 eight wells were drilled and 17 recompletion workovers were completed and 15 workovers are projected for 2007. As of December 31, 2006, proved reserves for the Jalmat field were approximately 48 Bcfe. Production in the fourth quarter of 2006 averaged 6 Mmcfe/d. Approximately 68% of the field production is oil.

Risk Management

We use hedges to reduce price volatility, help ensure that we have adequate cash flow to fund our capital programs and manage price risks and returns on some of our acquisitions and drilling programs. Our decision on the quantity and price at which we choose to hedge our production is based in part on our view of current and future market conditions. While there are many different types of derivatives available, we primarily use oil and natural gas price collars, swap agreements and put options to attempt to manage price risk more effectively. The collar agreements are put and call options used to establish floor and ceiling commodity prices for a fixed volume of production during a certain time period. They provide for payments to counterparties if the index price exceeds the ceiling and payments from the counterparties if the index price is below the floor. The price swaps call for payments to, or receipts from, counterparties based on whether the market price of oil and natural gas for the period is greater or less than the fixed price established for that period when the swap is put in place. Under put options, we pay a fixed premium to lock in a specified floor price. If the index price falls below the floor price, the counterparty pays us net of the fixed premium. If the index price rises above floor price, we pay the fixed premium.

We only enter into derivatives arrangements with credit worthy counterparties. These arrangements expose us to the risk of financial loss if our counterparty is unable to satisfy its obligations. We will continue to evaluate the benefit of employing derivatives in the future. See Item 7A. *Quantitative and Qualitative Disclosures about Market Risk* for additional information.

Oil and Natural Gas Operations

Our principal properties consist of developed and undeveloped oil and natural gas leases and the reserves associated with these leases. Generally, developed oil and natural gas leases remain in force as long as production is maintained. Undeveloped oil and natural gas leaseholds are generally for a primary term of three to five years. In most cases, the term of our undeveloped leases can be extended by paying delay rentals or by producing reserves that are discovered under those leases.

The table below sets forth the results of our drilling activities for the periods indicated:

	Years Ended December 31,					
	2006		2005		2004	
	Gross	Net	Gross	Net	Gross	Net
Exploratory Wells:						
Productive [(1)]	178	71.16	8	2.40	2	0.57
Dry	19	5.99	5	1.29	5	0.42
Total Exploratory	197	77.15	13	3.69	7	0.99
Development Wells:						
Productive [(1)]	132	59.78	129	27.40	61	10.79
Dry	1	0.02	4	1.35	3	0.15
Total Development	133	59.80	133	28.75	64	10.94
Total Wells:						
Productive [(1)]	310	130.94	137	29.80	63	11.36
Dry	20	6.01	9	2.64	8	0.57
Total	330	136.95	146	32.44	71	11.93

(1) *Although a well may be classified as productive upon completion, future production may deem the well to be uneconomical, particularly exploratory wells where there is no production history.*

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We own interests in developed and undeveloped oil and natural gas acreage in the locations set forth in the table below. These ownership interests generally take the form of working interests in oil and natural gas leases or licenses that have varying terms. The following table presents a summary of our acreage interests as of December 31, 2006:

	Developed Acreage		Undeveloped Acreage		Total Acreage	
	Gross	Net	Gross	Net	Gross	Net
State						
Alabama	1,920	174	27,389	13,695	29,309	13,869
Arkansas	15,881					