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CREDO PETROLEUM CORP
Form 10QSB
March 18, 2002

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-QSB

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

For Quarter Ended January 31, 2002

Commission File Number 0-8877

CREDO PETROLEUM CORPORATION

| | |
|---|-------------------------------|
| Colorado | 84-0772991 |
| (State of Incorporation) | (IRS Employer Identification) |
| 1801 Broadway, Suite 900 | 80202 |
| Denver, Colorado | (Zip Code) |
| (Address of principal executive office) | |
| 303-297-2200 | |
| (Telephone Number) | |

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 the number of shares outstanding of each of the issuer's classes of common stock, net of treasury stock, as of February 28, 2002: Common stock, \$.10 par value - 3,207,000
Preferred stock, no par value - None issued

CREDO PETROLEUM CORPORATION

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For Quarter Ended January 31, 2002

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PART I - FINANCIAL INFORMATION

Consolidated Balance Sheets As of January 31, 2002 (Unaudited)
and October 31, 2001

Consolidated Statements of Operations and Changes in Retained
Earnings (Unaudited) For the Three Month Periods Ended
January 31, 2002 and 2001

Consolidated Statements of Cash Flows (Unaudited) For the
Three Month Periods Ended January 31, 2002 and 2001

Management's Discussion and Analysis of Financial Condition and
Results of Operations

PART II - OTHER INFORMATION

Not Applicable

The consolidated financial statements included herein have been prepared by the company without audit, and reflect all adjustments which are, in the opinion of management, necessary for a fair presentation of the financial position of the company for the periods presented. Certain information and footnote disclosures normally included in the financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted as allowed by the rules and regulations of the Securities and Exchange Commission. These financial statements should be read in conjunction with the company's Form 10-KSB for the fiscal year ended October 31, 2001.

CREDO PETROLEUM CORPORATION Consolidated Balance Sheets

A S S E T S

| | January 31, 2002 | October 31, 2001 |
|---------------------------|---------------------|---------------------|
| | ----- | ----- |
| | (Unaudited) | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 980,000 | \$ 819,000 |
| Short term investments | 5,560,000 | 5,283,000 |
| Receivables: | | |
| Trade | 273,000 | 317,000 |
| Accrued oil and gas sales | 340,000 | 367,000 |
| Other | 508,000 | 241,000 |
| | ----- | ----- |
| | 7,661,000 | 7,027,000 |
| | ----- | ----- |

OIL AND GAS PROPERTIES, net,

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at cost, full cost method:

| | | |
|-------------|-----------|-----------|
| Unevaluated | 1,665,000 | 1,549,000 |
| Evaluated | 6,925,000 | 7,120,000 |
| | ----- | ----- |
| | 8,590,000 | 8,669,000 |
| | ----- | ----- |

EXCLUSIVE LICENSE AGREEMENT,
net of amortization of
\$100,000 in 2002
and \$82,000 in 2001

| | |
|---------|---------|
| 600,000 | 618,000 |
| ----- | ----- |

OTHER, net

| | |
|---------|---------|
| 180,000 | 156,000 |
| ----- | ----- |

| | |
|--------------|--------------|
| \$17,031,000 | \$16,470,000 |
| ===== | ===== |

L I A B I L I T I E S A N D S T O C K H O L D E R S '
E Q U I T Y

CURRENT LIABILITIES:

| | | |
|----------------------|------------|--------------|
| Accounts payable | \$ 979,000 | \$ 1,126,000 |
| Income taxes payable | 180,000 | 110,000 |
| | ----- | ----- |
| | 1,159,000 | 1,236,000 |
| | ----- | ----- |

DEFERRED HEDGING GAINS

| | |
|---------|-------|
| 110,000 | - |
| ----- | ----- |

DEFERRED INCOME TAXES

| | |
|-----------|-----------|
| 2,021,000 | 1,935,000 |
| ----- | ----- |

EXCLUSIVE LICENSE OBLIGATION,

less current portion of \$44,000

| | |
|---------|---------|
| 456,000 | 456,000 |
| ----- | ----- |

COMMITMENTS

STOCKHOLDERS' EQUITY:

| | | |
|--|--------------|--------------|
| Preferred stock, without par value, 5,000,000 shares authorized, none issued | - | - |
| Common stock, \$.10 par value, 20,000,000 shares authorized, 3,678,000 shares issued | 367,000 | 367,000 |
| Capital in excess of par value | 6,453,000 | 6,453,000 |
| Retained earnings | 7,137,000 | 6,927,000 |
| Other comprehensive income | 201,000 | 14,000 |
| Treasury stock, at cost, 471,000 shares in 2002 and 502,000 shares in 2001 | (873,000) | (918,000) |
| | ----- | ----- |
| | 13,285,000 | 12,843,000 |
| | ----- | ----- |
| | \$17,031,000 | \$16,470,000 |
| | ===== | ===== |

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See accompanying notes.

CREDO PETROLEUM CORPORATION
 Consolidated Statements of Operations And Changes in
 Retained Earnings - Unaudited

| | Three Months Ended | |
|---|--------------------|--------------|
| | January 31, | |
| | 2002 | 2001 |
| | ----- | ----- |
| REVENUES: | | |
| Oil and gas sales | \$ 1,046,000 | \$ 1,376,000 |
| Operating | 126,000 | 109,000 |
| Investment income and other | 9,000 | 92,000 |
| | ----- | ----- |
| | 1,181,000 | 1,577,000 |
| | ----- | ----- |
| COSTS AND EXPENSES: | | |
| Oil and gas production | 360,000 | 311,000 |
| Depreciation, depletion and amortization | 266,000 | 183,000 |
| General and administrative | 243,000 | 210,000 |
| Interest | 12,000 | 13,000 |
| | ----- | ----- |
| | 881,000 | 717,000 |
| | ----- | ----- |
| INCOME BEFORE INCOME TAXES | 300,000 | 860,000 |
| INCOME TAXES | (90,000) | (258,000) |
| | ----- | ----- |
| NET INCOME | 210,000 | 602,000 |
| RETAINED EARNINGS, BEGINNING OF PERIOD | 6,927,000 | 4,925,000 |
| | ----- | ----- |
| RETAINED EARNINGS, END OF PERIOD | \$ 7,137,000 | \$ 5,527,000 |
| | ===== | ===== |
| BASIC NET INCOME PER SHARE | \$.07 | \$.20 |
| | ===== | ===== |
| DILUTED NET INCOME PER SHARE | \$.06 | \$.19 |
| | ===== | ===== |

See accompanying notes.

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CREDO PETROLEUM CORPORATION
Consolidated Statements of Cash Flows - Unaudited

| | Three Months Ended | |
|--|--------------------|------------|
| | January 31, | |
| | 2002 | 2001 |
| | ----- | ----- |
| OPERATING ACTIVITIES: | | |
| Net income | \$ 210,000 | \$ 602,000 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation, depletion and amortization | 266,000 | 183,000 |
| Deferred hedging gains | 110,000 | - |
| Deferred income taxes | 86,000 | 106,000 |
| Changes in operating assets and liabilities: | | |
| Proceeds from short term investments | 1,006,000 | 250,000 |
| Purchase of short term investments | (1,283,000) | (214,000) |
| Trade receivables | 44,000 | (284,000) |
| Accrued oil and gas sales | 27,000 | (296,000) |
| Other | (80,000) | (22,000) |
| Accounts payable | (147,000) | 203,000 |
| Income tax payable | 70,000 | (18,000) |
| | ----- | ----- |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 309,000 | 510,000 |
| | ----- | ----- |
| INVESTING ACTIVITIES: | | |
| Oil and gas properties, net | (157,000) | (630,000) |
| Changes in other long-term assets | (36,000) | (20,000) |
| | ----- | ----- |
| NET CASH USED IN INVESTING ACTIVITIES | (193,000) | (650,000) |
| | ----- | ----- |
| FINANCING ACTIVITIES: | | |
| Proceeds from exercise of stock options (35,000 options in 2002 and 117,000 in 2001) | 68,000 | 226,000 |
| Purchase of treasury stock (4,000 shares in 2002 and 5,000 in 2001) | (23,000) | (25,000) |
| | ----- | ----- |
| NET CASH PROVIDED BY FINANCING | | |

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| | | |
|--|----------------|----------------|
| ACTIVITIES | 45,000 | 201,000 |
| | ----- | ----- |
| INCREASE IN CASH AND CASH EQUIVALENTS | 161,000 | 61,000 |
| CASH AND CASH EQUIVALENTS: | | |
| Beginning of Period | 819,000 | 484,000 |
| | ----- | ----- |
| End of Period | \$ 980,000 | \$ 545,000 |
| | ===== | ===== |

See accompanying notes.

CREDO PETROLEUM CORPORATION
Management's Discussion and Analysis of Financial
Condition and Results of Operations
January 31, 2002

LIQUIDITY AND CAPITAL RESOURCES

The company's working capital and cash flow represent a significant capital resource and source of liquidity. At January 31, 2002, working capital was \$6,392,000, compared to \$5,791,000 at October 31, 2001. Cash flow from operating activities before working capital changes totaled \$672,000 for the three months, compared to \$891,000 from the same period last year.

Existing working capital and anticipated cash flow are expected to be sufficient to fund fiscal 2002 operations. However, if the company were to make one or more major acquisition during the coming year, bank borrowing, issuance of additional stock, or other forms of debt financing would be considered. Because earnings are anticipated to be reinvested in operations, cash dividends are not expected to be paid in the foreseeable future.

Pending deployment into oil and gas assets, cash is primarily invested with professional money managers who specialize in short-term timing of mutual funds. The average return on the company's investments was minimal for the three months of fiscal 2002 compared to 2% in the same period last year. The lower investment return was due primarily to market conditions during the first quarter of 2002 that limited investment opportunities for the market timers which manage the bulk of the company's investments.

Commitments for future capital expenditures were approximately \$500,000 at January 31, 2002. The timing of most capital expenditures for exploration and development is relatively discretionary. Therefore, the company can plan expenditures to coincide with available funds in order to minimize business risks.

PRODUCT PRICES, PRODUCTION AND OPERATIONS

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Numerous uncertainties exist in the oil and gas exploration and production industry which are beyond the company's ability to predict with reasonable accuracy.

Gas price decontrol, the advent of an active spot market for natural gas, changes in supply and demand for natural gas, and weather patterns cause prices received by the company to be subject to significant fluctuations. Gas prices generally accelerate in peak demand periods such as the winter months and subside during lower demand periods.

Significant world events and OPEC's production and pricing policies influence OPEC and worldwide supply and demand and prices for crude oil and petroleum products.

Although product prices are key to the company's ability to operate profitably and to budget capital expenditures, they are beyond the company's control and are difficult to predict. The company periodically hedges the price of its oil and gas production when the potential for significant downward price movement is anticipated. Hedging transactions take the form of forward, or "short", selling in the NYMEX futures market, and are closed by purchasing offsetting "long" positions. Such hedges, which are accounted for as cash flow hedges, do not exceed anticipated production volumes, are expected to have reasonable correlation between price movements in the futures market and the cash markets where the company's production is located, and are authorized by the company's Board of Directors. Hedges are expected to be closed and gains or losses recognized for financial reporting purposes as related production occurs. However, hedges may be closed earlier if the anticipated downward price movement occurs or if the company believes that the potential for such movement has abated. All other futures transactions are accounted for as speculative transactions and gains and losses are immediately recognized.

At January 31, 2002, open hedge positions totaled 310,000 Mcfg (thousand cubic feet of gas) covering the months of March through July 2002 at an average price of \$3.20 per Mcf. Subsequent to first quarter end, 70 MMcfg was added to the hedge at an average price of \$3.04 per Mcf. This hedge represents approximately 78% of the company's estimated production for those months. The original hedge represented approximately 94% of estimated production for the March through July 2002 period, however, the Glendena #1-5 well was drilled after the hedge was set and added substantial new production that caused the percent of hedged production to be substantially lower than originally intended.

The company deferred a realized gain of \$110,000 for the February hedge (70,000 Mcf) which was closed prior to first quarter end. Subsequent to first quarter-end, the March hedge (70,000 Mcf) was closed and a \$77,000 gain was realized.

The company recognizes all derivatives on the balance sheet at fair value at the end of each period. Changes in the fair value of a cash flow hedge are recorded in Other Comprehensive Income on the Consolidated Balance Sheets and then are reclassified into the Consolidated Statement of Earnings as the underlying hedged item affects earnings. Amounts reclassified into earnings related to natural gas hedges are included in oil

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and gas sales. At January 31, 2002, unrealized gains of approximately \$287,000 (\$201,000 net of tax) related to natural gas hedging transactions were accumulated in Other Comprehensive Income.

The following table sets forth the components of Comprehensive Income for each of the periods presented:

| | Three Months Ended January 31, | |
|---|-----------------------------------|------------|
| | 2002 | 2001 |
| | ----- | ----- |
| Net Income | \$ 210,000 | \$ 602,000 |
| Other comprehensive income, net of tax: | | |
| Change in fair value of derivatives | 187,000 | 60,000 |
| | ----- | ----- |
| Comprehensive income | \$ 397,000 | \$ 662,000 |
| | ===== | ===== |

Oil and gas sales volume and price comparisons for the indicated periods are set forth below.

| Product | Three Months Ended January 31, 2002 | | Three Months Ended January 31, 2001 | | Percent Volume Change | Percent Price Change |
|------------|--|------------|--|---------|-----------------------------|----------------------------|
| | Volume | Price | Volume | Price | | |
| ----- | ----- | ----- | ----- | ----- | ----- | ----- |
| Gas (Mcf) | 290,600 | \$ 3.02(1) | 164,600 | \$ 6.20 | +77% | -51% |
| Oil (bbls) | 9,600 | \$17.33 | 11,900 | \$29.82 | -19% | -42% |

(1) Includes \$.64 Mcf hedging gain.

The company's growth strategy focuses on two core projects—drilling along the Anadarko Shelf of Oklahoma and application of its patented Calliope gas recovery technology.

Natural gas production increased 77% compared to the same period last year primarily because of new wells drilled during fiscal 2001. The most important of those wells was the 7,600-foot Glendena #1-5 well which tested the Morrow formation on the company's 1,960-acre Sand Creek Prospect in Ellis and Harper Counties, Oklahoma. The exploratory well encountered two Morrow sands totaling 31 feet which calculate productive on logs. It was completed naturally (without acid or fracture treatments) from only one of the two sands. Pipeline sales commenced in late October, 2001 and the well has since produced on choke at an average daily rate of about 3.0 MMcfg, six barrels of condensate, and no water. The second sand will be developed at a future date. The Glendena well contributed approximately 32% of first quarter production and accounted for 74% of the first quarter production increase. CREDO is operator of the well and owns a 40% working interest.

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A north offset to the Glendena well has been drilled and is awaiting completion. The well is currently classified by the company as a "tight hole", meaning that for proprietary business reasons the company is not releasing information about the well. The company anticipates that additional wells will be drilled on the prospect.

Also in Harper County, Oklahoma, the company has commenced an exploratory well on its 1,320-acre Two Springs Prospect located approximately six miles north of the Glendena well. The well is on the same Morrow sand trend and targets both the Morrow and Chester formations at 7,450 feet. In Ellis County, Oklahoma, the company is preparing to drill a second well on its 640-acre Thurmond Prospect. The well targets the Morrow formation at 8,650 feet.

The company is actively generating drilling prospects along the Anadarko Shelf of Oklahoma and is currently leasing on several projects located in the general area of its Two Springs and Sand Creek Prospects.

The company has installed its patented Calliope Gas Recovery System on eight wells ranging in depth from 6,500 to 18,600 feet. Each of these applications was a rigorous test for Calliope. Three applications were on dead wells - one for five years - that were scheduled to be plugged and abandoned. After being reinvigorated by Calliope, these three wells are currently CREDO's second, third and seventh most valuable producing properties. Calliope wells accounted for 16% of the company's gas production volume in the first quarter of fiscal 2002, and they represent 24% of the company's estimated proved reserve quantities at fiscal 2001 year-end.

The company is actively seeking to acquire wells, or enter into arrangements with other companies, for application of its Calliope Gas Recovery System. The run-up in gas prices during 2000 and 2001 severely hindered the company's efforts to purchase wells for Calliope. However, the recent sharp decline in gas prices appears to have improved acquisition opportunities. The purchase of two Calliope wells is currently being finalized, and negotiations are in progress to purchase several other wells.

In addition, the company is considering other strategies to install Calliope on more wells such as joint venturing with certain large companies, and is developing a highly sophisticated multimedia presentation to market Calliope.

As a gas well depletes, technologies that rely on bottom hole pressure to lift liquids that load-up the well and restrict gas flow become inefficient. In many gas wells, the operating limits of conventional liquid lift technologies cause billions of cubic feet of gas to be left behind and substantial profits to be lost. For those wells, Calliope will achieve substantially lower reservoir abandonment pressure than conventional production methods because it does not rely on bottom hole pressure or adequate fluid volumes to lift liquids.

The company has proved to its satisfaction that Calliope will add .5 to 2.0 Bcf of gas reserves to many dead or uneconomic gas wells. The 11,800-foot J. C. Carroll well provides an excellent example of Calliope's potential. When the well was

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purchased for salvage value in 1999, it had not produced commercially in five years. Calliope immediately restored production to 660 thousand cubic feet of gas per day. The company estimates that Calliope will recover 1.7 billion cubic feet of additional gas from the Carroll well. It is the company's second most valuable asset.

INCOME TAXES

The company accounts for income taxes in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (SFAS 109), which requires the asset and liability method of accounting for deferred income taxes. Deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities. Deferred tax assets or liabilities at the end of each period are determined using the tax rate in effect at that time.

The total future deferred income tax liability under SFAS 109 is extremely complicated for any oil company to estimate due in part to the long-lived nature of depleting oil and gas reserves and variables such as product prices. Accordingly, the liability is subject to continual recalculation, revision of the numerous estimates required, and may change significantly in the event of such things as major acquisitions, divestitures, product price changes, changes in reserve estimates, changes in reserve lives, and changes in tax rates or tax laws.

RESULTS OF OPERATIONS

Quarter Ended January 31, 2002 Compared to Quarter Ended January 31, 2001

Net income for the quarter ended January 31, 2002 fell 65% to \$210,000 compared to \$602,000 for the same quarter last year. Although successful drilling boosted production 77%, lower net income resulted primarily from the combination of sharply lower prices (natural gas down 51% and oil down 42%), much lower investment returns, and the high cost of a major well workover.

Total revenues fell 25% to \$1,181,000 in the first quarter of 2002 compared to \$1,577,000 for the same quarter last year. Oil and gas sales fell 24% to \$1,046,000 compared to \$1,376,000 last year. Refer to the table and discussion on pages 7 and 8 for details of oil and gas prices and volumes for the applicable periods. Net wellhead natural gas prices fell 62% to \$2.38 per Mcf compared to \$6.20 last year. However, hedging transactions added \$.64 per Mcf to first quarter gas price realizations. As a result, total natural gas price realizations were \$3.02 per Mcf compared to \$6.20 last year. There were no hedging transactions last year. Net wellhead prices for oil fell 42% to \$17.33 per barrel compared to \$29.82 last year. The net effect of these price changes and hedging transactions was to reduce oil and gas sales \$591,000. Gas volumes increased 77% and oil volumes fell 19%. The net effect of volume changes was to increase oil and gas sales \$261,000. Operating income increased \$17,000, or 16%, due to increased drilling supervision income and the addition of several operated wells. As discussed on page 6, the average return on the company's investments was minimal in the current quarter compared to 2% last year due primarily to market conditions during the current quarter that limited investment

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opportunities for the market timers which manage the bulk of the company's investments.

Total costs and expenses increased 23% to \$881,000 in the first quarter of 2002 compared to \$717,000 last year. Oil and gas production expenses rose 16%, or \$49,000 due to a major well workover that cost approximately \$60,000. Depreciation, depletion and amortization increased 45% primarily due to a net increase in production volume between the periods. General and administrative expenses increased \$33,000, or 16%, due to inflationary pressures and additional staffing. Interest expense relates to the accrual of interest on the exclusive license agreement obligation, due annually on September 1st. Income taxes were provided at 30% in both periods.

FORWARD-LOOKING STATEMENTS

Certain information included in this quarterly report and other materials filed by the company with the Commission contain forward-looking statements relating to the company's operations and the oil and gas industry. Such forward-looking statements are based on management's current projections and estimates and are identified by words such as "expects," "intends," "plans," "projects," "anticipates," "believes," "estimates" and similar words. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual results may differ materially from what is expressed or forecasted in such forward-looking statements. Among many factors that could cause actual results to differ materially are: (i) natural gas and crude oil price fluctuations, (ii) the company's ability to acquire oil and gas properties that meet its objectives and to identify prospects for drilling, and (iii) potential delays or failure to achieve expected production from existing and future exploration and development projects. In addition, such forward-looking statements may be affected by general domestic and international economic and political conditions.

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.

Date: March 14, 2002 By: /s/ James T. Huffman

James T. Huffman
President and Chief Executive Officer

By: /s/ John A. Alsko

John A. Alsko
Vice President and
Chief Financial Officer