

ARENA RESOURCES INC  
Form 10-Q  
August 07, 2007

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

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 2007

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 Number 001-31657

**ARENA RESOURCES, INC.**

(Exact name of registrant as specified in its charter)

Nevada  
(State or other jurisdiction of  
incorporation or organization)

73-1596109  
(I.R.S. Employer  
Identification No.)

4920 South Lewis Street, Suite 107

Tulsa, Oklahoma 74105

(Address of principal executive offices)

(918) 747-6060  
(Registrant's telephone number)

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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 past 12 months, and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):  
 Yes  No

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

As of July 30, 2007, the Company had outstanding 17,001,263 shares of common stock (\$0.001 par value).

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**Part I – Financial Information**

**Item 1. Financial Statements:**

The condensed consolidated financial statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading.

In the opinion of the Company, all adjustments, consisting of only normal recurring adjustments, necessary to present fairly the consolidated financial position of the Company and the consolidated results of its operations and its cash flows have been made. The results of its operations and its cash flows for the three and six months ended June 30, 2007 are not necessarily indicative of the results to be expected for the year ending December 31, 2007.

**ARENA RESOURCES, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(UNAUDITED)**

	<b>June 30, 2007</b>	<b>December 31, 2006</b>
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash	\$ 47,957,170	\$ 4,919,984
Accounts receivable	8,043,435	6,702,677
Joint interest billing receivable	2,867,835	2,949,099
Prepaid expenses	329,178	102,585
<b>Total Current Assets</b>	<b>59,197,618</b>	<b>14,674,345</b>
<b>Property and Equipment, Using Full Cost Accounting</b>		
Oil and gas properties subject to amortization	225,126,382	171,708,200
Equipment	60,051	59,332
Drilling rigs	3,879,948	1,996,899
Office buildings and land	1,941,232	-
Office equipment	126,128	120,929
<b>Total Property and Equipment</b>	<b>231,133,741</b>	<b>173,885,360</b>
Less: Accumulated depreciation and amortization	(17,659,867)	(12,246,727)
<b>Net Property and Equipment</b>	<b>213,473,874</b>	<b>161,638,633</b>
<b>Total Assets</b>	<b>\$ 272,671,492</b>	<b>\$ 176,312,978</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 9,954,441	\$ 14,367,252
Accrued liabilities	803,838	628,618
<b>Total Current Liabilities</b>	<b>10,758,279</b>	<b>14,995,870</b>
<b>Long-Term Liabilities</b>		
Notes payable	-	19,300,000
Notes payable to related parties	-	400,000
Asset retirement liability	2,466,231	2,250,332
Deferred income taxes	23,507,028	19,322,724
<b>Total Long-Term Liabilities</b>	<b>25,973,259</b>	<b>41,273,056</b>
<b>Stockholders' Equity</b>		
Preferred stock - \$0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding	-	-
Common stock - \$0.001 par value; 100,000,000 shares authorized; 17,001,263 shares and 14,668,787 shares outstanding, respectively	17,001	14,669
Additional paid-in capital	183,177,620	81,872,268
Options and warrants outstanding	3,853,938	2,872,988
Retained earnings	48,891,395	35,284,127

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<b>Total Stockholders' Equity</b>	235,939,954	120,044,052
<b>Total Liabilities and Stockholders' Equity</b>	\$ 272,671,492	\$ 176,312,978

See the accompanying notes to unaudited condensed consolidated financial statements.

**ARENA RESOURCES, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**

	For the Three Months Ended		For the Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
<b>Oil and Gas Revenues</b>	\$ 21,620,299	\$ 14,690,068	\$ 38,271,600	\$ 25,070,463
<b>Costs and Operating Expenses</b>				
Oil and gas production costs	2,615,533	1,290,409	4,976,482	2,668,828
Oil and gas production taxes	1,216,832	909,445	2,175,483	1,606,654
Depreciation, depletion and amortization	2,659,712	1,408,999	5,317,267	2,461,461
Accretion expense	45,265	33,638	88,762	62,942
General and administrative expense	1,799,579	768,484	3,034,365	1,472,416
<b>Total Costs and Operating Expenses</b>	8,336,921	4,410,975	15,592,359	8,272,301
<b>Other Income (Expense)</b>				
Other financing expense	-	-	-	(785,598)
Interest expense	(727,064)	(48,579)	(1,080,403)	(95,263)
<b>Net Other Expense</b>	(727,064)	(48,579)	(1,080,403)	(880,861)
<b>Income Before Provision for Income Taxes</b>	12,556,314	10,230,514	21,598,838	15,917,301
<b>Provision for Deferred Income Taxes</b>	(4,656,936)	(3,785,290)	(7,991,570)	(5,889,401)
<b>Net Income</b>	\$ 7,899,378	\$ 6,445,224	\$ 13,607,268	\$ 10,027,900
<b>Basic Net Income Per Common Share</b>	0.52	0.47	0.91	0.74
<b>Diluted Net Income Per Common Share</b>	0.49	0.44	0.86	0.70

See the accompanying notes to unaudited condensed consolidated financial statements.

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ARENA RESOURCES, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

<i>For the Six Months Ended June 30,</i>	<b>2007</b>	<b>2006</b>
<b>Cash Flows From Operating Activities</b>		
Net income	\$ 13,607,268	\$ 10,027,900
Adjustments to reconcile net income to net cash provided by operating activities:		
Warrants issued for financing expense	-	785,598
Depreciation, depletion and amortization	5,317,267	2,461,461
Provision for income taxes	7,991,570	5,889,401
Stock based compensation	1,520,751	393,300
Accretion of asset retirement obligation	88,762	62,942
Changes in assets and liabilities:		
Accounts and joint interest receivable	(1,259,494)	(3,035,274)
Other changes in deferred income taxes	-	(222,657)
Prepaid expenses	(226,593)	(320,058)
Excess tax benefits from share-based payment arrangements	(3,807,266)	(1,851,813)
Accounts payable and accrued liabilities	(4,282,610)	604,634
<b>Net Cash Provided by Operating Activities</b>	<b>18,949,655</b>	<b>14,795,434</b>
<b>Cash Flows from Investing Activities</b>		
Purchase and development of oil and gas properties	(55,061,822)	(34,194,713)
Proceeds from sale of oil and gas properties	1,915,640	-
Purchase of buildings, land & equipment	(3,830,199)	(704,379)
<b>Net Cash Used in Investing Activities</b>	<b>(56,976,381)</b>	<b>(34,899,092)</b>
<b>Cash Flows From Financing Activities</b>		
Proceeds from issuance of common stock, net of offering costs	95,399,643	29,858,463
Proceeds from exercise of warrants	270,003	150,000
Proceeds from exercise of options	1,287,000	640,000
Excess tax benefits from share-based payment arrangements	3,807,266	1,851,813
Funds received and held for call options	-	1,272,093
Proceeds from issuance of notes payable	30,700,000	11,000,000
Payment of notes payable	(50,400,000)	(11,000,000)
<b>Net Cash Provided by Financing Activities</b>	<b>81,063,912</b>	<b>33,772,369</b>
<b>Net Increase in Cash</b>	<b>43,037,186</b>	<b>13,668,711</b>
<b>Cash at Beginning of Period</b>	<b>4,919,984</b>	<b>4,317,114</b>
<b>Cash at End of Period</b>	<b>\$ 47,957,170</b>	<b>\$ 17,985,825</b>
<b>Supplemental Cash Flow Information</b>		
Cash paid for income taxes	\$ -	\$ 329,986
Cash paid for interest	1,232,467	180,702
<b>Non-Cash Investing and Financing Activities</b>		
Common stock issued for properties and equipment	\$ -	\$ 3,507,872
Asset retirement obligation incurred in property development	172,156	113,807



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Depreciation on drilling rig capitalized as part of oil and gas properties	99,844	-
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See the accompanying notes to unaudited condensed consolidated financial statements.

ARENA RESOURCES, INC.  
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2007

**NOTE 1 – BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES**

**Condensed Consolidated Financial Statements** – The accompanying condensed consolidated financial statements have been prepared by the Company and are unaudited. In the opinion of management, the accompanying unaudited financial statements contain all adjustments necessary for fair presentation, consisting of normal recurring adjustments, except as disclosed herein.

The accompanying unaudited interim financial statements have been condensed pursuant to the rules and regulations of the Securities and Exchange Commission; therefore, certain information and disclosures generally included in financial statements have been condensed or omitted. The condensed financial statements should be read in conjunction with the Company's annual financial statements included in its annual report on Form 10-K as of December 31, 2006. The financial position and results of operations for the three and six months ended June 30, 2007 are not necessarily indicative of the results to be expected for the full year ending December 31, 2007.

**Nature of Operations** – Arena Resources, Inc. (the "Company") owns interests in oil and gas properties located in Oklahoma, Texas, Kansas and New Mexico. The Company is engaged primarily in the acquisition, exploration and development of oil and gas properties and the production and sale of oil and gas. In 2006, the Company formed two wholly owned subsidiaries, Arena Drilling Co. and ARD Production Company. Arena Drilling Co. was formed to oversee the operation of the Company's drilling rig that began operating in May 2006. ARD Production was formed to hold LZS Corporation, an acquisition the Company made in November 2006. The accompanying statements of operations and cash flows include the operations of the above subsidiaries from the date of acquisition/formation.

**Consolidation** – The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

**Use of Estimates** – The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Oil and Gas Properties** – The Company uses the full cost method of accounting for oil and gas properties. Under this method, all costs associated with acquisition, exploration, and development of oil and gas reserves are capitalized. Costs capitalized include acquisition costs, geological and geophysical expenditures, lease rentals on undeveloped properties and costs of drilling and equipping productive and non-productive wells. Drilling costs include directly related overhead costs. Capitalized costs are categorized either as being subject to amortization or not subject to amortization.

All capitalized costs of oil and gas properties, including the estimated future costs to develop proved reserves and estimated future costs of abandonment and site restoration, are amortized on the unit-of-production method using estimates of proved reserves as determined by independent engineers. Investments in unproved properties and major development projects are not amortized until proved reserves associated with the projects can be determined. The Company evaluates oil and gas properties for impairment at least quarterly. Amortization expense for the three and six months ended June 30, 2007 was \$2,659,712 and \$5,317,267, respectively, based on depletion at the rate of \$7.24 per barrel of oil equivalent compared to \$1,408,999 and \$2,461,461 based on depletion at the rate of \$5.59 per barrel of oil equivalent for the three and six months ended June 30, 2006, respectively. These amounts include \$8,696 and \$41,942 for the three months ended June 30, 2007 and 2006, respectively and \$17,133 and \$48,351 of depreciation on equipment during the six months ended June 30, 2007 and 2006, respectively.



**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**JUNE 30, 2007**

In addition, capitalized costs are subject to a ceiling test which limits such costs to the estimated present value of future net revenues from proved reserves, discounted at a 10-percent interest rate, based on current economic and operating conditions, plus the lower of cost or fair market value of unproved properties. Consideration received from sales or transfers of oil and gas property is accounted for as a reduction of capitalized costs. Revenue is not recognized in connection with contractual services performed on properties in which the Company holds an ownership interest.

**Buildings and Equipment** – Buildings and equipment are valued at historical cost adjusted for impairment loss less accumulated depreciation. Historical costs include all direct costs associated with the acquisition of buildings and equipment and placing them in service.

Depreciation of buildings and equipment is calculated using the straight-line method based upon the following estimated useful lives:

Buildings and improvements	30 years
Drilling rigs	10 years
Office equipment and software	5-7 years
Machinery and equipment	5-7 years

Maintenance and repairs are charged to expense as incurred. Renovations and improvements are capitalized. Buildings and equipment of the Company are evaluated for impairment annually.

**Basic and Diluted Income Per Common Share** – Basic income per common share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted income per share reflects the potential dilution that could occur if all contracts to issue common stock were converted into common stock, except for those that are anti-dilutive. The dilutive effect of stock options and other share based compensation is calculated using the treasury method with an offset from expected proceeds upon exercise of the stock options and unrecognized compensation expense.

**Concentration of Credit Risk and Major Customer** – The Company has cash in excess of federally insured limits at June 30, 2007. During the three and six months ended June 30, 2007, sales to two customers represented 83% and 12% of oil and gas revenues, respectively. At June 30, 2007, these customers made up 84% and 11% of accounts receivable, respectively.

**Recent Accounting Pronouncements** – In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 establishes a common definition for fair value to be applied to United States GAAP guidance requiring use of fair value, establishes a framework for measuring fair value, and expands disclosure about such fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. We are currently assessing the impact of SFAS No. 157 on our consolidated financial position and results of operations.

**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**JUNE 30, 2007**

**NOTE 2 – EARNINGS PER SHARE INFORMATION**

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
Net Income	\$ 7,899,378	\$ 6,445,224	\$ 13,607,268	\$ 10,027,900
Basic Weighted-Average Common Shares Outstanding	15,236,867	13,779,031	14,997,860	13,478,876
Effect of dilutive securities				
Warrants	200,722	252,981	203,604	247,955
Stock options	686,183	680,252	676,547	674,350
Diluted Weighted-Average Common Shares Outstanding	16,123,772	14,712,264	15,878,011	14,401,181
Basic Income Per Common Share				
Net income	0.52	0.47	0.91	0.74
Diluted Income Per Common Share				
Net Income	0.49	0.44	0.86	0.70

For the three and six months ended June 30, 2007, 450,000 stock options were not included in the computation of diluted income per share as their effects are anti-dilutive.

**NOTE 3 – PROPERTY AND EQUIPMENT**

**Acquisition of Oil and Gas Properties** - In January 2006, the Company entered into a definitive agreement to reacquire the working interests and related rights in two different prospects in Comanche and Hamilton Counties, Kansas with combined acreage totaling approximately 20,000 acres. During 2005 the Company sold working interest rights in multiple wells drilled on these prospects, along with rights to participate in additional wells on the acreage. Total consideration provided for the re-acquisitions of these rights and interests was 120,800 shares of common stock, issued in February 2006, valued at \$3,326,832, or \$27.54 per share.

**Divestiture of Oil and Gas Properties** - In June 2007, the Company entered into an agreement to sell the working interest and related rights in the West San Andres property, which the Company had acquired in October 2003 for a cash payment of \$500,000. Total proceeds to the Company from the sale of this property were \$1,915,000, net of related costs of the sell. Under the full cost method of accounting, the proceeds were offset against oil and gas properties subject to amortization.

**Acquisition of office buildings** – In March 2007, the Company acquired an office building, land and adjoining parcel of real estate in Tulsa, Oklahoma to serve as its executive offices. The building was purchased with a cash payment of \$1,900,000. The building is currently being renovated and the Company anticipates occupying the building in October 2007. We will not begin to depreciate the buildings until they are occupied and in use.

**NOTE 4 – NOTES PAYABLE**

*Credit facility* - In April 2006, the Company entered into an agreement that increased its credit facility to \$15 0,000,000, with an increased borrowing base of \$65,000,000. The interest rate was a floating rate equal to the 30, 60 or 90 day LIBOR rate plus 2%, and is payable monthly. Amounts borrowed under the revolving credit facility are due in May 2009. The revolving credit facility is secured by the Company's principal mineral interests. In order to obtain the revolving credit facility, loans from two officers were subordinated to the position of the bank. The Company is required under the terms of the credit facility to maintain a 5-to-1 ratio of income before interest, taxes, depreciation, depletion and amortization to interest expense, maintain a current asset to current liability ratio of 1-to-1 and a requirement to maintain a maximum leverage ratio of no more than 2.5-to-1, calculated on a rolling four quarter basis.

**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**JUNE 30, 2007**

In June 2007, the Company entered into a new agreement that increased the borrowing base under its credit facility to \$100,000,000, while leaving the credit facility at \$150,000,000. Additionally, the interest rate was changed to be a floating rate equal to the 30, 60 or 90 day LIBOR rate plus 1.75%. Additionally, the subordination of the loans from two officers was released. All other terms and conditions remained the same. As of June 30, 2007, the Company was in compliance with all covenants and no amount was outstanding under this credit facility.

**Related party notes payable** – Previously, two officers of the Company and Board of Directors had lent money to the Company in the form of notes payable in the amount of \$400,000. During the six months ended June 30, 2007, the Company paid off the notes payable to the two officers along with any accrued interest.

**NOTE 5 – ASSET RETIREMENT OBLIGATION**

The Company provides for the obligation to plug and abandon oil and gas wells at the dates properties are either acquired or the wells are drilled. The asset retirement obligation is adjusted each quarter for any liabilities incurred or settled during the period, accretion expense and any revisions made to the estimated cash flows. The reconciliation of the asset retirement obligation for the six months ended June 30, 2007 is as follows:

Balance, January 1, 2007	\$ 2,250,332
Liabilities incurred	198,488
Accretion expense	88,762
Deletions related to property divestitures	(26,332)
Liabilities settled	(45,019)
 Balance, June 30, 2007	 \$ 2,466,231

**NOTE 6 - STOCKHOLDERS' EQUITY**

**Warrants exercised** – During the six months ended June 30, 2007, the Company issued 27,476 shares of common stock from the exercise of warrants for proceeds of \$270,003. Of these warrants, 10,000 had an exercise price of \$9.00 per share and 17,476 had an exercise price of \$10.30 per share.

**Common Stock Issued in Offerings** – In June 2007, the Company issued 2,050,000 shares of common stock, valued at \$100,450,000, or \$49.00 per share, in a private placement. Proceeds from the offering totaled \$95.4 million, net of offering costs paid as of June 30, 2007.

**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**JUNE 30, 2007**

**NOTE 7 – EMPLOYEE STOCK OPTIONS**

Compensation expense charged against income for stock based awards during the three and six months ended June 30, 2007 was \$881,127 and \$1,520,751, respectively, as compared to \$213,533 and \$393,300 for the three and six months ended June 30, 2006, respectively, and is included in general and administrative expense in the accompanying financial statements.

In January and May 2007, the Company granted nonqualified stock options to directors and employees to purchase 450,000 shares of common stock, with options for 50,000 shares having an exercise price of \$37.35 per share, options for 300,000 shares having an exercise price of \$38.46 per share and options for 100,000 shares having an exercise price of \$46.84 per share. The options vest at the rate of 20% each year over five years beginning one year from the date granted. A summary of the status of the stock options as of June 30, 2007 and changes during the six months ended June 30, 2007 is as follows:

	<b>Options</b>		<b>Weighted-Average Exercise Price</b>
Outstanding at December 31, 2006	1,305,000	\$	5.79
Issued	450,000		40.20
Forfeited	(57,500)		6.70
Exercised	(255,000)		5.05
Outstanding at June 30, 2007	1,442,500		17.35
Exercisable at June 30, 2007	535,000	\$	5.15
Weighted average fair value of options granted during the period ended June 30, 2007		\$	18.37

The following are the weighted-average assumptions used for options granted during the six months ended June 30, 2007:

	<u><b>2007</b></u>
Risk free interest rate	4.73%
Expected life	5 years
Dividend yield	-
Volatility	44.74%

The expected life of stock options represents the period of time that the stock options granted are expected to be outstanding based on historical exercise trends. The expected volatility is based on the historical price volatility of our common stock. The risk-free interest rate represents the U.S. Treasury bill rate for the expected life of the related stock options. The dividend yield represents our anticipated cash dividend over the expected life of the stock options.

The 255,000 options exercised during the six months ended June 30, 2007 had an intrinsic value of \$10,329,700. Associated with the exercise of stock options, the Company received a tax benefit of \$3,807,266 during the six months ended June 30, 2007. The tax benefit is recorded as an



increase in additional paid in capital.

**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**JUNE 30, 2007**

As of June 30, 2007, there was approximately \$6,924,846 of unrecognized compensation cost related to stock options that will be recognized over a weighted average period of 4.5 years. The aggregate intrinsic value of options expected to vest at June 30, 2007 was \$51,714,454. The aggregate intrinsic value of options exercisable at June 30, 2007 was \$28,865,450. The intrinsic value is based on a June 29, 2007 closing price of the Company's common stock of \$58.11.

**NOTE 8 – CONTINGENCIES AND COMMITMENTS**

*Standby Letters of Credit* – A commercial bank has issued standby letters of credit on behalf of the Company to the states of Texas, Oklahoma, New Mexico and Kansas totaling \$527,500 to allow the Company to do business in those states. The standby letters of credit are valid until cancelled or matured and are collateralized by the revolving credit facility with the bank. Letter of credit terms range from one to five years. The Company intends to renew the standby letters of credit for as long as the Company does business in those states. No amounts have been drawn under the standby letters of credit.

**NOTE 9 - SUBSEQUENT EVENTS**

Subsequent to June 30, 2007, the Company acquired an office building in Hobbs, New Mexico to serve as its primary field office for its Permian Basin properties. The building was purchased with a cash payment of \$357,500.

Subsequent to June 30, 2007, the Company entered into an agreement for zero-cost collars on a portion of oil production, equal to 1,000 net barrels of oil per day, beginning in August 2007 and continuing through December 2008. Under the collar agreements, the Company will receive the difference between an agreed upon average NYMEX WTI index price and a floor price of \$65.00, if the index price is below the floor price. The Company will pay the difference between the agreed upon contracted ceiling price of \$80.50 and the index price only if the index price is above the contracted ceiling price. No amounts are paid or received if the index price is between the contracted floor and ceiling prices. We have designated these derivatives for hedge accounting as cash flow hedges.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*Results of Operations – For the Three Months Ended June 30, 2007*

*Oil and natural gas sales.* For the three months ended June 30, 2007, oil and natural gas sales revenue increased \$6,930,231 to \$21,620,299, compared to \$14,690,068 for the same period during 2006. Oil sales increased \$5,366,007 and natural gas sales increased \$1,564,224. The increases were primarily the result of our increased volumes due to our development throughout 2006 and 2007. For the three months ended June 30, 2007, oil sales volume increased 119,368 barrels to 327,290 barrels, compared to 207,922 barrels for the same period in 2006. The average realized per barrel oil price decreased 11% from \$64.37 for the three months ended June 30, 2006 to \$57.29 for the three months ended June 30, 2007. For the three months ended June 30, 2007, gas sales volume increased 149,341 thousand cubic feet (MCF) to 348,169 MCF, compared to 198,828 MCF for the same period in 2006. The average realized natural gas price per MCF increased 25% from \$6.57 for the three months ended June 30, 2006 to \$8.24 for the three months ended June 30, 2007.

*Oil and gas production costs.* Our lease operating expenses (LOE) increased from \$1,290,409 or \$5.35 per barrel of oil equivalent (BOE) for the three months ended June 30, 2006 to \$2,615,533 or \$6.79 per BOE for the three months ended June 30, 2007. The increase in total LOE was due to our development projects throughout 2006 and 2007. The increase in the per BOE amounts is a result of rising rates for labor and services and additional costs for repairs as a result of weather and other factors.

*Production taxes.* Production taxes as a percentage of oil and natural gas sales were 6% during the three months ended June 30, 2006 and remained steady at 6% for the three months ended June 30, 2007. Production taxes vary from state to state. Therefore, these taxes may vary in the future depending on the mix of production we generate from various states, as well as the possibility that any state may raise its production tax rate.

*Depreciation, depletion and amortization.* Our depreciation, depletion and amortization expense increased by \$1,250,713 to \$2,659,712 for the three months ended June 30, 2007, compared to the same period in 2006. The increase was primarily a result of an increase in volume and in the average depletion rate from \$5.59 per BOE during the three months ended June 30, 2006 to \$6.89 per BOE during the three months ended June 30, 2007. The increased depletion rate was the result of increased capitalized costs and development costs.

*General and administrative expenses.* General and administrative expenses increased by \$1,031,095 to \$1,799,579 for the three months ended June 30, 2007, compared to the same period in 2006. A portion of this increase was due to an increase in the stock-based compensation expense recognized under FASB 123(R) of \$667,594. The remaining increase was primarily related to increases in compensation expense associated with an increase in personnel required to administer our growth.

*Interest expense (net of interest income).* Net interest expense increased \$678,485 to \$727,064 for the three months ended June 30, 2007 when compared to the same period in 2006. The increase was due to higher average outstanding debt over the full quarter.

*Income tax expense.* Our effective tax rate was 37% during the three months ended June 30, 2006 and remained steady at 37% for the three months ended June 30, 2007.

*Net income.* Net income increased from \$6,445,224 for the three months ended June 30, 2006 to \$7,899,378 for the same period in 2007. The primary reasons for this increase include increased volumes as a result of the development of our properties, partially offset by lower crude oil prices, higher lease operating expense, general and administrative expense and income tax expense due to our growth.



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*Results of Operations – For the Six Months Ended June 30, 2007*

*Oil and natural gas sales.* For the six months ended June 30, 2007, oil and natural gas sales revenue increased \$13,201,137 to \$38,271,600, compared to \$25,070,463 for the same period during 2006. Oil sales increased \$10,621,384 and natural gas sales increased \$2,579,933. The increases were primarily the result of our increased volumes due to our development throughout 2006 and 2007. For the six months ended June 30, 2007, oil sales volume increased 234,739 barrels to 609,828 barrels, compared to 375,089 barrels for the same period in 2006. The average realized per barrel oil price decreased 10% from \$60.59 for the six months ended June 30, 2006 to \$54.70 for the six months ended June 30, 2007. For the six months ended June 30, 2007, gas sales volume increased 332,240 MCF to 673,104 MCF, compared to 340,864 MCF for the same period in 2006. The average realized natural gas price per MCF increased 6% from \$6.88 for the six months ended June 30, 2006 to \$7.30 for the six months ended June 30, 2007.

*Oil and gas production costs.* Our lease operating expenses (LOE) increased from \$2,668,828 or \$6.18 per BOE for the six months ended June 30, 2006 to \$4,976,482 or \$6.89 per BOE for the six months ended June 30, 2007. The increase in total LOE was due to our development projects throughout 2006 and 2007. The increase in the per BOE amounts is a result of rising rates for labor and services and additional costs for repairs as a result of weather and other factors.

*Production taxes.* Production taxes as a percentage of oil and natural gas sales were 6% during the six months ended June 30, 2006 and remained steady at 6% for the six months ended June 30, 2007. Production taxes vary from state to state. Therefore, these taxes may vary in the future depending on the mix of production we generate from various states, as well as the possibility that any state may raise its production tax rate.

*Depreciation, depletion and amortization.* Our depreciation, depletion and amortization expense increased by \$2,855,806 to \$5,317,267 for the six months ended June 30, 2007, compared to the same period in 2006. The increase was primarily a result of an increase in volume and in the average depletion rate from \$5.59 per BOE during the six months ended June 30, 2006 to \$7.24 per BOE during the six months ended June 30, 2007. The increased depletion rate was the result of increased capitalized costs and development costs.

*General and administrative expenses.* General and administrative expenses increased by \$1,561,949 to \$3,034,365 for the six months ended June 30, 2007, compared to the same period in 2006. A portion of this increase was due to an increase in the stock-based compensation expense recognized under FASB 123(R) of \$1,127,451. The remaining increase was primarily related to increases in compensation expense associated with an increase in personnel required to administer our growth.

*Other financing expense.* Other financing expense was \$0 for the six months ended June 30, 2007, compared to \$785,598 for the same period in 2006. This financing expense relates to the issuance in the first quarter of 2006 of warrants associated with the 2005 private offering and subsequent registration of common stock.

*Interest expense (net of interest income).* Net interest expense increased \$985,140 to \$1,080,403 for the six months ended June 30, 2007 when compared to the same period in 2006. The increase was due to higher average outstanding debt over the six months.

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*Income tax expense.* Our effective tax rate was 37% during the six months ended June 30, 2006 and remained steady at 37% for the six months ended June 30, 2007.

*Net income.* Net income increased from \$10,027,900 for the six months ended June 30, 2006 to \$13,607,268 for the same period in 2007. The primary reasons for this increase include increased volumes as a result of the development of our properties, partially offset by lower crude oil prices between periods, higher lease operating expense, general and administrative expense and income tax expense due to our growth.

### *Revenues Year to Date by Geographic section*

Arena reports its net oil and gas revenues for the year to date as applicable to the following geographic sectors:

#### **OIL**

	Net Production Volume		Net Revenue
Texas Leases	488,906 BBLS	\$	26,646,843
Oklahoma Leases	18,843 BBLS	\$	1,099,042
New Mexico Leases	102,079 BBLS	\$	5,613,903

#### **GAS**

	Net Production Volume		Net Revenue
Texas Leases	424,226 MCF	\$	3,198,256
Oklahoma Leases	9,776 MCF	\$	53,020
New Mexico Leases	159,222 MCF	\$	1,304,157
Kansas Leases	79,880 MCF	\$	356,378

### *Significant Subsequent Events occurring after June 30, 2007:*

Subsequent to June 30, 2007, the Company acquired an office building in Hobbs, New Mexico to serve as its primary field office for its Permian Basin properties. The building was purchased with a cash payment of \$357,500.

Subsequent to June 30, 2007, the Company entered into an agreement for zero-cost collars on a portion of our oil production through December 2008. Under the collar agreements, we will receive the difference between an agreed upon average NYMEX WTI index price and a floor price if the index price is below the floor price. We will pay the difference between the agreed upon contracted ceiling price and the index price only if the index price is above the contracted ceiling price. No amounts are paid or received if the index price is between the contracted floor and ceiling prices. We have designated these derivatives for hedge accounting treatment as cash flow hedges.

### *Capital Resources and Liquidity*

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As shown in the financial statements for the six months ended June 30, 2007, the Company had cash on hand of \$47,957,170, compared to \$4,919,984 as of December 31, 2006. The Company had net cash provided by operating activities for the six months ended June 30, 2007 of \$18,949,655, compared to \$14,795,434 for the same period 2006. Other significant sources of cash inflow during the six months ended June 30, 2007 and 2006, were from issuances of common stock net of offering costs of \$95,399,643 in 2007 and \$29,858,463 in 2006, draw downs on the Company's credit facility of \$30,700,000 in 2007 and \$11,000,000 in 2006 and proceeds from option exercises of \$1,287,000 in 2007 and \$640,000 in 2006 and proceeds from the sale of oil and gas properties of \$1,915,640 in 2007. The most significant cash outflows during the six months ended June 30, 2007 and 2006 were capital expenditures of \$55,061,822 in 2007 and \$34,194,713 in 2006, purchases of building and equipment of \$3,830,199 in 2007 and \$704,379 in 2006 and repayment of notes payable \$50,400,000 in 2007 and \$11,000,000 in 2006.

**Credit facility** - In April 2006, the Company entered into an agreement that increased its credit facility to \$15 0,000,000, with an increased borrowing base of \$65,000,000. The interest rate was a floating rate equal to the 30, 60 or 90 day LIBOR rate plus 2%, and is payable monthly. Amounts borrowed under the revolving credit facility are due in May 2009. The revolving credit facility is secured by the Company's principal mineral interests. In order to obtain the revolving credit facility, loans from two officers were subordinated to the position of the bank. The Company is required under the terms of the credit facility to maintain a 5-to-1 ratio of income before interest, taxes, depreciation, depletion and amortization to interest expense, maintain a current asset to current liability ratio of 1-to-1 and a requirement to maintain a maximum leverage ratio of no more than 2.5-to-1, calculated on a rolling four quarter basis

In June 2007, the Company entered into a new agreement that increased the borrowing base under its credit facility to \$100,000,000, while leaving the credit facility at \$150,000,000. Additionally, the interest rate was changed to be a floating rate equal to the 30, 60 or 90 day LIBOR rate plus 1.75%. Additionally, the subordination of the loans from two officers was released. All other terms and conditions remained the same. As of June 30, 2007, the Company was in compliance with all covenants and no amount was outstanding under this credit facility.

**Related party notes payable** – Previously, two officers of the Company and Board of Directors had lent money to the Company in the form of notes payable in the amount of \$400,000. During the six months ended June 30, 2007, the Company paid off the notes payable to the two officers along with any accrued interest.

#### *Disclosures About Market Risks*

Like other natural resource producers, Arena faces certain unique market risks. The two most salient risk factors are the volatile prices of oil and gas and certain environmental concerns and obligations.

#### Oil and Gas Prices

Current competitive factors in the domestic oil and gas industry are unique. The actual price range of crude oil is largely established by major international producers. Pricing for natural gas is more regional. Because domestic demand for oil and gas exceeds supply, there is little risk that all current production will not be sold at relatively fixed prices. To this extent Arena does not see itself as directly competitive with other producers, nor is there any significant risk that the Company could not sell all production at current prices with a reasonable profit margin. The risk of domestic overproduction at current prices is not deemed significant. The primary competitive risks would come from falling international prices which could render current production uneconomical.

Secondarily, Arena is presently committed to use the services of the existing gatherers in its present areas of production. This gives to such gatherers certain short term relative monopolistic powers to set gathering and transportation costs, because obtaining the services of an alternative gathering company would require substantial additional costs since an alternative gatherer would be required to lay new pipeline and/or obtain new rights-of-way in the lease.



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It is also significant that more favorable prices can usually be negotiated for larger quantities of oil and/or gas product, such that Arena views itself as having a price disadvantage to larger producers. Large producers also have a competitive advantage to the extent they can devote substantially more resources to acquiring prime leases and resources to better find and develop prospects.

### Environmental

Oil and gas production is a highly regulated activity which is subject to significant environmental and conservation regulations both on a federal and state level. Historically, most of the environmental regulation of oil and gas production has been left to state regulatory boards or agencies in those jurisdictions where there is significant gas and oil production, with limited direct regulation by such federal agencies as the Environmental Protection Agency. However, while the Company believes this generally to be the case for its production activities in Texas, Oklahoma, Kansas and New Mexico, it should be noticed that there are various Environmental Protection Agency regulations which would govern significant spills, blow-outs, or uncontrolled emissions.

In Oklahoma, Texas, Kansas and New Mexico specific oil and gas regulations exist related to the drilling, completion and operations of wells, as well as disposal of waste oil. There are also procedures incident to the plugging and abandonment of dry holes or other non-operational wells, all as governed by the Oklahoma Corporation Commission, Oil and Gas Division, the Texas Railroad Commission, Oil and Gas Division, the Kansas Corporation Commission, Oil and Gas Division or the New Mexico Oil Conservation Division.

Compliance with these regulations may constitute a significant cost and effort for Arena. No specific accounting for environmental compliance has been maintained or projected by Arena to date. Arena does not presently know of any environmental demands, claims, or adverse actions, litigation or administrative proceedings in which it or the acquired properties are involved or subject to or arising out of its predecessor operations.

In the event of a breach of environmental regulations, these environmental regulatory agencies have a broad range of alternative or cumulative remedies to include: ordering a clean up of any spills or waste material and restoration of the soil or water to conditions existing prior to the environmental violation; fines; or enjoining further drilling, completion or production activities. In certain egregious situations the agencies may also pursue criminal remedies against the Company or its principals.

### *Forward-Looking Information*

Certain statements in this Section and elsewhere in this report are forward-looking in nature and relate to trends and events that may affect the Company's future financial position and operating results. Such statements are made pursuant to the safe harbor provision of the *Private Securities Litigation Reform Act of 1995*. The terms "expect," "anticipate," "intend," and "project" and similar words or expressions are intended to identify forward-looking statements. These statements speak only as of the date of this report. The statements are based on current expectations, are inherently uncertain, are subject to risks, and should be viewed with caution. Actual results and experience may differ materially from the forward-looking statements as a result of many factors, including changes in economic conditions in the markets served by the company, increasing competition, fluctuations in raw materials and energy prices, and other unanticipated events and conditions. It is not possible to foresee or identify all such factors. The company makes no commitment to update any forward-looking statement or to disclose any facts, events, or circumstances after the date hereof that may affect the accuracy of any forward-looking statement.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

*Interest Rate Risk*

The Company is subject to interest rate risk on its revolving credit facility, which bears variable interest based upon a LIBOR rate. Changes in interest rates affect the interest earned on the Company's cash and cash equivalents and the interest rate paid on borrowings under its bank credit facility. Currently, the Company does not use interest rate derivative instruments to manage exposure to interest rate changes.

*Commodity Price Risk*

The Company's revenues, profitability and future growth depend substantially on prevailing prices for oil and natural gas. Prices also affect the amount of cash flow available for capital expenditures and Arena's ability to borrow and raise additional capital. The amount the Company can borrow under its bank credit facility is subject to periodic redetermination based in part on changing expectations of future prices. Lower prices may also reduce the amount of oil and natural gas that the Company can economically produce. Arena currently sells all of its oil and natural gas production under price sensitive or market price contracts.

As of June 30, 2007, Arena did not use derivative commodity instruments or similar financial instruments to attempt to hedge commodity price risks associated with future oil and natural gas production. However, please see Note 2, Significant Subsequent Events occurring after June 30, 2007.

*Currency Exchange Rate Risk*

Foreign sales accounted for none of the Company's sales; further, the Company accepts payment for its commodity sales only in U.S. dollars; hence, Arena is not exposed to foreign currency exchange rate risk on these sales.

**Item 4. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

The Company maintains controls and procedures designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. At the end of the period covered by this Quarterly Report on Form 10-Q, the Company's management, under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that as of the end of such period the Company's disclosure control and procedures are effective in alerting them to material information that is required to be included in the reports the Company files or submits under the Securities Exchange Act of 1934.

*Changes in Internal Controls Over Financial Reporting*

There have been no changes in the Company's internal control over financial reporting during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Part II - Other Information**

**Item 1. Legal Proceedings**

None.

**Item 1A. Risk Factors**

There have been no material changes from risk factors as previously disclosed in our Form 10-K in response to Item 1A to Part I of Form 10-K.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

- |     |                     |                                   |
|-----|---------------------|-----------------------------------|
| (a) | <u>Exhibit 31.1</u> | Section 302 Certification of CEO  |
|     | <u>Exhibit 31.2</u> | Section 302 Certification of CFO  |
| (b) | <u>Exhibit 32.1</u> | Section 1350 Certification of CEO |
|     | <u>Exhibit 32.2</u> | Section 1350 Certification of CFO |



**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

REGISTRANT: **ARENA RESOURCES, INC.**

Dated: August 6, 2007

By: /s/ Lloyd Tim Rochford  
Lloyd Tim Rochford  
Chief Executive Officer

Dated: August 6, 2007

By: /s/ Phillip W. Terry  
Phillip W. Terry  
President

Dated: August 6, 2007

By: /s/ William R. Broaddrick  
William R. Broaddrick  
Vice President, Chief Financial Officer