

CALLON PETROLEUM CO

Form 10-Q

May 09, 2006

Table of Contents

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**  
**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF**  
**THE SECURITIES EXCHANGE ACT OF 1934**

**For the Quarterly Period Ended March 31, 2006**

**Commission File Number 001-14039**

**CALLON PETROLEUM COMPANY**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**64-0844345**

(I.R.S. Employer  
Identification No.)

**200 North Canal Street**  
**Natchez, Mississippi 39120**

(Address of principal executive offices)(Zip code)

**(601) 442-1601**

(Registrant's telephone number,  
including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☐ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definitions 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 Exchange Act Rule 12b-2). Yes ☐ No ☐

As of May 5, 2006, there were 20,313,141 shares of the Registrant's Common Stock, par value \$0.01 per share, outstanding.

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**CALLON PETROLEUM COMPANY**  
**TABLE OF CONTENTS**

|                                                                                                                          | <b>Page<br/>No.</b> |
|--------------------------------------------------------------------------------------------------------------------------|---------------------|
| <b>Part I. Financial Information</b>                                                                                     |                     |
| <u>Consolidated Balance Sheets as of March 31, 2006 and December 31, 2005</u>                                            | 3                   |
| <u>Consolidated Statements of Operations for the Three Months in the Periods Ended March 31, 2006 and March 31, 2005</u> | 4                   |
| <u>Consolidated Statements of Cash Flows for the Three Months in the Periods Ended March 31, 2006 and March 31, 2005</u> | 5                   |
| <u>Notes to Consolidated Financial Statements</u>                                                                        | 6                   |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                     | 14                  |
| <u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>                                                | 20                  |
| <u>Item 4. Controls and Procedures</u>                                                                                   | 20                  |
| <b>Part II. Other Information</b>                                                                                        |                     |
| <u>Item 6. Exhibits</u>                                                                                                  | 21                  |
| <u>2006 Stock Incentive Plan</u>                                                                                         |                     |
| <u>Certification of Chief Executive and Chief Financial Officer Pursuant to Section 302</u>                              |                     |
| <u>Certification of Chief Executive and Chief Financial Officer Pursuant to Section 906</u>                              |                     |

**Table of Contents**

**Callon Petroleum Company**  
**Consolidated Balance Sheets**  
(In thousands, except share data)

|                                                           | <b>March 31,<br/>2006<br/>(Unaudited)</b> | <b>December<br/>31,<br/>2005<br/>(Note 1)</b> |
|-----------------------------------------------------------|-------------------------------------------|-----------------------------------------------|
| <b>ASSETS</b>                                             |                                           |                                               |
| Current assets:                                           |                                           |                                               |
| Cash and cash equivalents                                 | \$ 5,139                                  | \$ 2,565                                      |
| Accounts receivable                                       | 30,683                                    | 33,195                                        |
| Deferred tax asset                                        | 37,788                                    | 26,770                                        |
| Restricted investments                                    | 4,152                                     | 4,110                                         |
| Fair market value of derivatives                          | 2,165                                     | 889                                           |
| Other current assets                                      | 1,077                                     | 1,998                                         |
| Total current assets                                      | 81,004                                    | 69,527                                        |
| Oil and gas properties, full-cost accounting method:      |                                           |                                               |
| Evaluated properties                                      | 985,614                                   | 937,698                                       |
| Less accumulated depreciation, depletion and amortization | (553,235)                                 | (539,399)                                     |
|                                                           | 432,379                                   | 398,299                                       |
| Unevaluated properties excluded from amortization         | 55,013                                    | 49,065                                        |
| Total oil and gas properties                              | 487,392                                   | 447,364                                       |
| Other property and equipment, net                         | 1,618                                     | 1,605                                         |
| Long-term gas balancing receivable                        | 723                                       | 403                                           |
| Restricted investments-long-term                          | 1,877                                     | 1,858                                         |
| Investment in Medusa Spar LLC                             | 11,835                                    | 11,389                                        |
| Other assets, net                                         | 1,515                                     | 1,630                                         |
| Total assets                                              | \$ 585,964                                | \$ 533,776                                    |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>               |                                           |                                               |
| Current liabilities:                                      |                                           |                                               |
| Accounts payable and accrued liabilities                  | \$ 44,798                                 | \$ 39,323                                     |
| Fair market value of derivatives                          | 653                                       | 1,247                                         |
| Undistributed oil and gas revenues                        | 1,176                                     | 721                                           |
| Asset retirement obligations                              | 27,040                                    | 21,660                                        |
| Current maturities of long-term debt                      | 236                                       | 263                                           |
| Total current liabilities                                 | 73,903                                    | 63,214                                        |

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|                                                                             |            |            |
|-----------------------------------------------------------------------------|------------|------------|
| Long-term debt                                                              | 194,218    | 188,813    |
| Asset retirement obligations-long-term                                      | 25,298     | 16,613     |
| Deferred tax liability                                                      | 49,018     | 31,633     |
| Accrued liabilities to be refinanced                                        |            | 5,000      |
| Other long-term liabilities                                                 | 458        | 455        |
| Total liabilities                                                           | 342,895    | 305,728    |
| Stockholders' equity:                                                       |            |            |
| Preferred Stock, \$.01 par value, 2,500,000 shares authorized;              |            |            |
| Common Stock, \$.01 par value, 30,000,000 shares authorized; 20,293,779 and |            |            |
| 19,357,138 shares outstanding at March 31, 2006 and December 31, 2005,      |            |            |
| respectively                                                                | 203        | 194        |
| Capital in excess of par value                                              | 217,996    | 220,360    |
| Unearned compensation restricted stock                                      |            | (3,334)    |
| Other comprehensive income (loss)                                           | 944        | (331)      |
| Retained earnings                                                           | 23,926     | 11,159     |
| Total stockholders' equity                                                  | 243,069    | 228,048    |
| Total liabilities and stockholders' equity                                  | \$ 585,964 | \$ 533,776 |

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

**Table of Contents**

**Callon Petroleum Company**  
**Consolidated Statements of Operations**  
**(Unaudited)**  
**(In thousands, except per share amounts)**

|                                          | <b>Three Months Ended<br/>March 31,</b> |             |
|------------------------------------------|-----------------------------------------|-------------|
|                                          | <b>2006</b>                             | <b>2005</b> |
| Operating revenues:                      |                                         |             |
| Oil sales                                | \$ 27,799                               | \$ 24,009   |
| Gas sales                                | 17,782                                  | 19,003      |
| Total operating revenues                 | 45,581                                  | 43,012      |
| Operating expenses:                      |                                         |             |
| Lease operating expenses                 | 5,905                                   | 6,536       |
| Depreciation, depletion and amortization | 13,836                                  | 15,408      |
| General and administrative               | 1,726                                   | 1,694       |
| Accretion expense                        | 1,419                                   | 861         |
| Derivative expense                       | 90                                      | 379         |
| Total operating expenses                 | 22,976                                  | 24,878      |
| Income from operations                   | 22,605                                  | 18,134      |
| Other (income) expenses:                 |                                         |             |
| Interest expense                         | 4,148                                   | 4,569       |
| Other (income) expense                   | (330)                                   | (202)       |
| Total other (income) expenses            | 3,818                                   | 4,367       |
| Income before income taxes               | 18,787                                  | 13,767      |
| Income tax expense                       | 6,550                                   | 4,818       |
| Income before Medusa Spar LLC            | 12,237                                  | 8,949       |
| Income from Medusa Spar LLC, net of tax  | 530                                     | 526         |
| Net income                               | 12,767                                  | 9,475       |
| Preferred stock dividends                |                                         | 318         |
| Net income available to common shares    | \$ 12,767                               | \$ 9,157    |

Net income per common share:

|       |         |         |
|-------|---------|---------|
| Basic | \$ 0.66 | \$ 0.52 |
|-------|---------|---------|

|         |         |         |
|---------|---------|---------|
| Diluted | \$ 0.60 | \$ 0.46 |
|---------|---------|---------|

Shares used in computing net income:

|       |        |        |
|-------|--------|--------|
| Basic | 19,396 | 17,671 |
|-------|--------|--------|

|         |        |        |
|---------|--------|--------|
| Diluted | 21,329 | 20,678 |
|---------|--------|--------|

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

**Table of Contents**

**Callon Petroleum Company**  
**Consolidated Statements of Cash Flows**  
**(Unaudited)**  
**(In thousands)**

|                                                                               | <b>Three Months Ended</b> |                       |
|-------------------------------------------------------------------------------|---------------------------|-----------------------|
|                                                                               | <b>March 31, 2006</b>     | <b>March 31, 2005</b> |
| Cash flows from operating activities:                                         |                           |                       |
| Net income                                                                    | \$ 12,767                 | \$ 9,475              |
| Adjustments to reconcile net income to cash provided by operating activities: |                           |                       |
| Depreciation, depletion and amortization                                      | 14,018                    | 15,543                |
| Accretion expense                                                             | 1,419                     | 861                   |
| Amortization of deferred financing costs                                      | 546                       | 490                   |
| Non-cash derivative expense                                                   | 90                        | 379                   |
| Income from investment in Medusa Spar LLC                                     | (530)                     | (526)                 |
| Deferred income tax expense                                                   | 6,550                     | 4,818                 |
| Non-cash charge related to compensation plans                                 | 115                       | 374                   |
| Excess tax benefits from share-based payment arrangements                     | (1,195)                   |                       |
| Changes in current assets and liabilities:                                    |                           |                       |
| Accounts receivable                                                           | 1,212                     | (6,965)               |
| Other current assets                                                          | 922                       | 265                   |
| Current liabilities                                                           | 5,483                     | (3,334)               |
| Change in gas balancing receivable                                            | (320)                     | 88                    |
| Change in gas balancing payable                                               | (2)                       | (68)                  |
| Change in other long-term liabilities                                         | 5                         | 4                     |
| Change in other assets, net                                                   | (64)                      | (73)                  |
| Cash provided by operating activities                                         | 41,016                    | 21,331                |
| Cash flows from investing activities:                                         |                           |                       |
| Capital expenditures                                                          | (39,507)                  | (16,206)              |
| Distribution from Medusa Spar LLC                                             | 370                       | 116                   |
| Cash used by investing activities                                             | (39,137)                  | (16,090)              |
| Cash flows from financing activities:                                         |                           |                       |
| Change in accrued liabilities to be refinanced                                | (5,000)                   |                       |
| Increase in debt                                                              | 14,000                    | 3,000                 |
| Payments on debt                                                              | (9,000)                   | (8,000)               |
| Issuance of common stock                                                      |                           | 1                     |
| Equity issued related to employee stock plans                                 | (418)                     | (87)                  |
| Excess tax benefits from share-based payment arrangements                     | 1,195                     |                       |
| Capital leases                                                                | (82)                      | (208)                 |
| Cash dividends on preferred stock                                             |                           | (318)                 |
| Cash provided (used) by financing activities                                  | 695                       | (5,612)               |

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|                                                      |          |          |
|------------------------------------------------------|----------|----------|
| Net increase (decrease) in cash and cash equivalents | 2,574    | (371)    |
| Cash and cash equivalents:                           |          |          |
| Balance, beginning of period                         | 2,565    | 3,266    |
| Balance, end of period                               | \$ 5,139 | \$ 2,895 |

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

5

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**Table of Contents**

**CALLON PETROLEUM COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**March 31, 2006**

**1. General**

The financial information presented as of any date other than December 31 has been prepared from the books and records of Callon Petroleum Company (the Company or Callon) without audit. Financial information as of December 31, 2005 has been derived from the audited financial statements of the Company, but does not include all disclosures required by U.S. generally accepted accounting principles. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, necessary for the fair presentation of the financial information for the periods indicated, have been included. For further information regarding the Company's accounting policies, refer to the Consolidated Financial Statements and related notes for the year ended December 31, 2005 included in the Company's Annual Report on Form 10-K filed March 15, 2006. The results of operations for the three-month period ended March 31, 2006 are not necessarily indicative of future financial results.

**2. Stock-Based Compensation**

The Company has various stock plans (Plans) under which employees of the Company and its subsidiaries and non-employee members of the Board of Directors of the Company have been or may be granted certain equity compensation. The Company has compensatory stock option plans in place whereby participants have been or may be granted rights to purchase shares of common stock of Callon. For further discussion of the Company's Plans, refer to Note 11 of the Consolidated Financial Statements for the year ended December 31, 2005 included in the Company's Annual Report on Form 10-K filed March 15, 2006.

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standard No. 123 (revised 2004), (SFAS 123R) Share-Based Payment, utilizing the modified prospective approach. Prior to the adoption of SFAS 123R we accounted for stock option grants in accordance with Accounting Principals Board Opinion No. 25,

Accounting for Stock Issued to Employees (the intrinsic value method) and, accordingly, recognized no compensation expense for stock option grants.

Under the modified prospective approach, SFAS 123R applies to new awards, unvested awards as of January 1, 2006 and awards that were outstanding on January 1, 2006 that are subsequently modified, repurchased or cancelled. Under the modified prospective approach, compensation cost recognized in the first quarter of 2006 includes compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of Statement of Financial Accounting Standard No. 123 (SFAS 123) Accounting for Stock-Based Compensation, and compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Prior periods were not restated to reflect the impact of adopting the new standard.

**Table of Contents**

As a result of most of the Company's stock-based compensation being in the form of restricted stock, the impact of the adoption of SFAS 123R on income before taxes, net income and basic and diluted earnings per share for the three-month period ended March 31, 2006 was immaterial.

We receive a tax deduction for certain stock option exercises during the period the options are exercised, generally for the excess of the price at which the options are sold over the exercise prices of the options. In accordance with SFAS 123R, for the three months ended March 31, 2006, we revised our consolidated statements of cash flows presentation to report the tax benefits from the exercise of stock options as financing cash flows. For the three months ended March 31, 2006, \$1.2 million of tax benefits were reported as financing cash flows rather than operating cash flows. There were no cash proceeds from the exercise of stock options for the three months ended March 31, 2006 due to the fact that all options were exercised through net-share settlements.

For the three month period ended March 31, 2006, we recorded compensation expense of \$217,000, \$108,000 of which was included in general and administrative expenses and \$109,000 of which was capitalized to oil and gas properties. Shares available for future stock option or restricted stock grants to employees and directors under existing plans were 916,974 at March 31, 2006.

The following table illustrates the effect on operating results and per share information had the Company accounted for stock-based compensation in accordance with SFAS 123 for the three months ended March 31, 2005 (in thousands, except per share amounts):

|                                                                                          | <b>Three Months<br/>Ended<br/>March 31, 2005</b> |
|------------------------------------------------------------------------------------------|--------------------------------------------------|
| Net income available to common shares as reported                                        | \$ 9,157                                         |
| Add: Stock-based compensation expense included in net income as reported, net of tax     | 191                                              |
| Deduct: Total stock-based compensation expense under fair value based method, net of tax | (230)                                            |
| Net income available to common shares pro forma                                          | \$ 9,118                                         |
| Net income per share available to common:                                                |                                                  |
| Basic-as reported                                                                        | \$ 0.52                                          |
| Basic-pro forma                                                                          | \$ 0.52                                          |
| Diluted-as reported                                                                      | \$ 0.46                                          |
| Diluted-pro forma                                                                        | \$ 0.46                                          |

**Table of Contents****Stock Options**

The Company uses the Black-Scholes option pricing model to estimate the fair value of stock-based awards with the following weighted-average assumptions for the indicated periods.

|                                        | <b>Three Months Ended<br/>March 31,</b> |             |
|----------------------------------------|-----------------------------------------|-------------|
|                                        | <b>2006</b>                             | <b>2005</b> |
| Dividend yield                         |                                         |             |
| Expected volatility                    | 38.9%                                   | 42.4%       |
| Risk-free interest rate                | 4.6%                                    | 4.4%        |
| Expected life of option (in years)     | 5                                       | 4           |
| Weighted-average grant-date fair value | 7.72                                    | 6.19        |
| Forfeiture rate                        | 7.5%                                    |             |

The assumptions above are based on multiple factors, including historical exercise patterns of employees with respect to exercise and post-vesting employment termination behaviors, expected future exercising patterns and the historical volatility of our stock price.

At March 31, 2006, there was \$284,000 of unrecognized compensation cost related to stock option share-based payments, which is expected to be recognized over a weighted-average period of 2.8 years.

The following table represents stock option activity for the three months ended March 31, 2006:

|                                            | <b>Number of<br/>Shares</b> | <b>Weighted-Average<br/>Exercise Price</b> | <b>Weighted-Average<br/>Remaining<br/>Contract Life</b> |
|--------------------------------------------|-----------------------------|--------------------------------------------|---------------------------------------------------------|
| Outstanding options at beginning of period | 1,205,558                   | \$ 10.11                                   |                                                         |
| Granted                                    | 15,000                      | 18.69                                      |                                                         |
| Exercised                                  | (384,650)                   | 10.65                                      |                                                         |
| Forfeited                                  |                             |                                            |                                                         |
| Outstanding options at end of period       | 835,908                     | 10.02                                      | 4.48 Yrs.                                               |
| Outstanding exercisable at end of period   | 787,908                     | \$ 9.55                                    | 4.17 Yrs.                                               |

The aggregate intrinsic value of options outstanding was \$9.2 million and the aggregate intrinsic value of options exercisable was \$9.0 million. Total intrinsic value of options exercised was \$3.4 million for the three months ended March 31, 2006.

**Table of Contents**

The following table summarizes our nonvested stock option activity for the three months ended March 31, 2006.

|                                                | <b>Number of<br/>Shares</b> | <b>Weighted-Average<br/>Exercise Price</b> |
|------------------------------------------------|-----------------------------|--------------------------------------------|
| Nonvested stock options at beginning of period | 39,000                      | \$ 16.94                                   |
| Granted                                        | 15,000                      | 18.69                                      |
| Vested                                         | (6,000)                     | 15.21                                      |
| Forfeited                                      |                             |                                            |
| Nonvested stock options at end of period       | 48,000                      | \$ 17.70                                   |

**Restricted Stock**

The Plans allow for the issuance of restricted stock awards. The unearned stock-based compensation related to these awards is being amortized to compensation expense over the vesting period, which ends in the third quarter of 2009. The share based expense for these awards was determined based on the market price of our stock at the date of grant applied to the total numbers of shares that were anticipated to fully vest. As of March 31, 2006, we have unearned stock-based compensation of \$3.1 million associated with these awards.

The following table represents restricted stock activity for the three months ended March 31, 2006.

|                                           | <b>Number of<br/>Shares</b> | <b>Weighted-Average<br/>Grant Price</b> |
|-------------------------------------------|-----------------------------|-----------------------------------------|
| Outstanding shares at beginning of period | 272,000                     | \$ 13.66                                |
| Granted                                   |                             |                                         |
| Vested                                    |                             |                                         |
| Forfeited                                 |                             |                                         |
| Outstanding shares at end of period       | 272,000                     | \$ 13.66                                |

**Table of Contents****3. Per Share Amounts**

Basic net income per common share was computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted net income per common share was determined on a weighted average basis using common shares issued and outstanding adjusted for the effect of common stock equivalents computed using the treasury stock method. In addition, an adjustment was included in 2005 for the effect of the convertible preferred stock.

A reconciliation of the basic and diluted earnings per share computation is as follows (in thousands, except per share amounts):

|                                                                                                                 | <b>Three Months Ended<br/>March 31,</b> |             |
|-----------------------------------------------------------------------------------------------------------------|-----------------------------------------|-------------|
|                                                                                                                 | <b>2006</b>                             | <b>2005</b> |
| (a) Net income available to common shares                                                                       | \$ 12,767                               | \$ 9,157    |
| Preferred dividends assuming conversion of preferred stock (if dilutive)                                        |                                         | 318         |
| (b) Income available to common shares assuming conversion of preferred stock (if dilutive)                      | \$ 12,767                               | \$ 9,475    |
| (c) Weighted average shares outstanding                                                                         | 19,396                                  | 17,671      |
| Dilutive impact of stock options                                                                                | 342                                     | 315         |
| Dilutive impact of warrants                                                                                     | 1,491                                   | 1,267       |
| Dilutive impact of restricted stock                                                                             | 100                                     | 69          |
| Convertible preferred stock (if dilutive)                                                                       |                                         | 1,356       |
| (d) Total diluted shares                                                                                        | 21,329                                  | 20,678      |
| Basic income per share (a,c)                                                                                    | \$ 0.66                                 | \$ 0.52     |
| Diluted income per share (b,d)                                                                                  | \$ 0.60                                 | \$ 0.46     |
| Stock options and warrants excluded due to the exercise price being greater than the stock price (in thousands) | 15                                      | 25          |

**4. Derivatives**

The Company periodically uses derivative financial instruments to manage oil and gas price risk. Settlements of gains and losses on commodity price contracts are generally based upon the difference between the contract price or prices specified in the derivative instrument and a NYMEX price or other cash or futures index price.

The Company's derivative contracts that are accounted for as cash flow hedges under Statement of Financial Accounting Standards No. 133 ( SFAS No. 133 ), Accounting for Derivative Instruments and Hedging Activities, are recorded at fair market value and the

**Table of Contents**

changes in fair value are recorded through other comprehensive income (loss), net of tax, in stockholders' equity. The cash settlements on these contracts are recorded as an increase or decrease in oil and gas sales. The changes in fair value related to ineffective derivative contracts are recognized as derivative expense (income). The cash settlements on these contracts are also recorded within derivative expense (income).

Cash settlements on effective cash flow hedges during the three-month periods ended March 31, 2006 and 2005 resulted in an increase in oil and gas sales of \$724,000 and a reduction of oil and gas sales of \$2.9 million, respectively. Derivative expense of \$90,000 and \$379,000 for the three-month periods ended March 31, 2006 and 2005, respectively, represents the amortization of derivative contract premiums.

As of March 31, 2006, the fair value of the outstanding gas derivative contracts was a current asset of \$2.2 million and the fair value of the outstanding oil contracts was a current liability of \$653,000.

Listed in the table below are the outstanding derivative contracts as of March 31, 2006:

**Swaps**

| Product | Volumes per<br>Month | Quantity<br>Type | Average<br>Price | Period      |
|---------|----------------------|------------------|------------------|-------------|
| Oil     | 15,000               | Bbls             | \$55.00          | 04/06-06/06 |

**Collars**

| Product     | Volumes per<br>Month | Quantity<br>Type | Average<br>Floor<br>Price | Average<br>Ceiling<br>Price | Period      |
|-------------|----------------------|------------------|---------------------------|-----------------------------|-------------|
| Oil         | 30,000               | Bbls             | \$60.00                   | \$77.10                     | 04/06-12/06 |
| Oil         | 30,000               | Bbls             | \$60.00                   | \$81.75                     | 04/06-12/06 |
| Natural Gas | 100,000              | MMBtu            | \$ 8.00                   | \$10.40                     | 04/06-06/06 |
| Natural Gas | 100,000              | MMBtu            | \$ 8.00                   | \$10.30                     | 07/06-09/06 |
| Natural Gas | 600,000              | MMBtu            | \$ 8.00                   | \$ 9.30                     | 04/06-12/06 |

**Table of Contents****5. Long-Term Debt**

Long-term debt consisted of the following at:

|                                                        | <b>March 31,<br/>2006</b> | <b>December<br/>31,<br/>2005</b> |
|--------------------------------------------------------|---------------------------|----------------------------------|
|                                                        | <b>(In<br/>thousands)</b> |                                  |
| Senior Secured Credit Facility (matures July 31, 2007) | \$ 5,000                  | \$                               |
| 9.75% Senior Notes (due 2010), net of discount         | 188,401                   | 187,941                          |
| Capital lease                                          | 1,053                     | 1,135                            |
| Total debt                                             | 194,454                   | 189,076                          |
| Less current portion:<br>Capital lease                 | 236                       | 263                              |
| Long-term debt                                         | \$ 194,218                | \$ 188,813                       |

On June 15, 2004, the Company closed on a three-year senior secured credit facility underwritten by Union Bank of California, N.A. The credit facility had an initial borrowing base of \$60 million, which was increased to \$70 million in the second quarter of 2005. The borrowing base is reviewed and redetermined semi-annually and can be increased to a maximum of \$175 million. Borrowings under the credit facility are secured by mortgages covering the Company's five largest fields. As of March 31, 2006, there was \$5 million outstanding under the facility with a weighted average interest rate of 6.38% and \$65 million available for future borrowings.

**6. Comprehensive Income**

A summary of the Company's comprehensive income (loss) is detailed below (in thousands):

|                                                    | <b>Three Months Ended<br/>March 31,</b> |             |
|----------------------------------------------------|-----------------------------------------|-------------|
|                                                    | <b>2006</b>                             | <b>2005</b> |
| Net income                                         | \$ 12,767                               | \$ 9,475    |
| Other comprehensive income (loss):                 |                                         |             |
| Change in fair value of effective cash flow hedges | 1,275                                   | (4,849)     |
| Total comprehensive income                         | \$ 14,042                               | \$ 4,626    |

**Table of Contents****7. Asset Retirement Obligations**

The following table summarizes the activity for the Company's asset retirement obligation for the three-month period ended March 31, 2006:

|                                                    | <b>Three Months<br/>Ended<br/>March 31, 2006</b> |
|----------------------------------------------------|--------------------------------------------------|
| Asset retirement obligation at beginning of period | \$ 38,273                                        |
| Accretion expense                                  | 1,419                                            |
| Liabilities incurred                               | 1,109                                            |
| Liabilities settled                                |                                                  |
| Revisions to estimate                              | 11,537                                           |
| Asset retirement obligation at end of period       | 52,338                                           |
| Less: current asset retirement obligation          | (27,040)                                         |
| Long-term asset retirement obligation              | \$ 25,298                                        |

The upward revisions to estimate were primarily due to a sharp increase in industry service cost for the Gulf of Mexico region experienced in the first quarter of 2006, principally as a result of the weather patterns during the second half of 2005.

Assets, primarily U.S. Government securities, of approximately \$6.0 million at March 31, 2006, are recorded as restricted investments. These assets are held in abandonment trusts dedicated to pay future abandonment costs for several of the Company's oil and gas properties.

**Table of Contents**

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

**Forward-Looking Statements**

This report includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements other than statements of historical facts included in this report, including statements regarding our financial position, adequacy of resources, estimated reserve quantities, business strategies, plans, objectives and expectations for future operations and covenant compliance, are forward-looking statements. We can give no assurances that the assumptions upon which such forward-looking statements are based will prove to have been correct. Important factors that could cause actual results to differ materially from our expectations ( Cautionary Statements ) are disclosed in the section entitled Risk Factors included in our Annual Report on Form 10-K for our most recent fiscal year, elsewhere in this report and from time to time in other filings made by us with the Securities and Exchange Commission. All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified by the Cautionary Statements.

**General**

Our revenues, profitability, future growth and the carrying value of our oil and gas properties are substantially dependent on prevailing prices of oil and gas, our ability to find, develop and acquire additional oil and gas reserves that are economically recoverable and our ability to develop existing proved undeveloped reserves. Our ability to maintain or increase our borrowing capacity and to obtain additional capital on attractive terms is also influenced by oil and gas prices. Prices for oil and gas are subject to large fluctuations in response to relatively minor changes in the supply of and demand for oil and gas, market uncertainty and a variety of additional factors beyond our control. These factors include weather conditions in the United States, the condition of the United States economy, the actions of the Organization of Petroleum Exporting Countries, governmental regulations, political stability in the Middle East and elsewhere, the foreign supply of oil and gas, the price of foreign imports and the availability of alternate fuel sources. Any substantial and extended decline in the price of oil or gas would have an adverse effect on the carrying value of our proved reserves, borrowing capacity, revenues, profitability and cash flows from operations. We use derivative financial instruments for price protection purposes on a limited amount of our future production, but do not use derivative financial instruments for trading purposes.

The following discussion is intended to assist in an understanding of our historical financial position and results of operations. Our historical financial statements and notes thereto included elsewhere in this quarterly report contain detailed information that should be referred to in conjunction with the following discussion.

**Table of Contents****Liquidity and Capital Resources**

Our primary sources of capital are cash flows from operations, borrowings from financial institutions and the sale of debt and equity securities. On March 31, 2006, we had net cash and cash equivalents of \$5 million and \$65 million of availability under our senior secured credit facility. Cash provided from operating activities during the three-month period ended March 31, 2006 totaled \$41 million. Cash provided by operating activities during the first quarter of 2006 increased 92% compared to 2005, due to increased oil and gas prices. Net capital expenditures from the cash flow statement for the three-month period ended March 31, 2006 totaled \$40 million.

Production of our reserves during 2006, without weather-related downtime, is projected to be higher than 2005 due to 10 new discoveries scheduled to commence initial production during 2006 which are expected to offset traditional declines from our current producing properties. Given the current pricing environment for oil and natural gas and the higher production volumes, our cash provided by operating activities for 2006 should exceed 2005.

Our capital expenditure plans for 2006, including capitalized interest and general and administrative expenses, will require \$150 million of funding. We expect that cash flow generated from operations during 2006 and current availability under our senior secured credit facility, if necessary, will provide the \$177 million of capital necessary to fund these planned capital expenditures as well as our asset retirement obligations. See the Capital Expenditures section below for a more detailed discussion of our capital expenditures for 2006.

The Indentures governing our 9.75% Senior Notes due 2010 and our senior secured credit facility contain various covenants, including restrictions on additional indebtedness and payment of cash dividends. In addition, our senior secured credit facility contains covenants for maintenance of certain financial ratios. We were in compliance with these covenants at March 31, 2006. See Note 5 of the Consolidated Financial Statements for the year ended December 31, 2005 included in our Annual Report on Form 10-K filed March 15, 2006 for a more detailed discussion of long-term debt.

The following table describes our outstanding contractual obligations (in thousands) as of March 31, 2006:

| <b>Contractual Obligations</b>          | <b>Total</b> | <b>Less Than One Year</b> | <b>One-Three Years</b> | <b>Four-Five Years</b> | <b>After-Five Years</b> |
|-----------------------------------------|--------------|---------------------------|------------------------|------------------------|-------------------------|
| Senior Secured Credit Facility          | \$ 5,000     | \$                        | \$ 5,000               | \$                     | \$                      |
| 9.75% Senior Notes                      | 200,000      |                           |                        | 200,000                |                         |
| Capital Lease (future minimum payments) | 1,581        | 401                       | 542                    | 449                    | 189                     |
| Throughput Commitments:                 |              |                           |                        |                        |                         |
| Medusa Spar                             | 11,776       | 3,772                     | 5,160                  | 2,844                  |                         |
| Medusa Oil Pipeline                     | 555          | 181                       | 172                    | 110                    | 92                      |
|                                         | \$ 218,912   | \$ 4,354                  | \$ 10,874              | \$ 203,403             | \$ 281                  |

**Table of Contents**

**Capital Expenditures**

Capital expenditures from the cash flow statement for exploration and development costs related to oil and gas properties totaled approximately \$40 million for the three months ended March 31, 2006. We incurred approximately \$27 million in costs in the Gulf of Mexico Shelf Area related primarily to the drilling of five wells, four successful and one in progress, and completion and development of seven discoveries. In the Onshore Louisiana area we incurred \$5 million, which was associated with the drilling and beginning stage of completion for our Prairie Beach discovery. Interest of approximately \$2 million and general and administrative costs allocable directly to exploration and development projects of approximately \$2 million were capitalized for the first three months of 2006. The remainder of the capital expended includes the acquisition of seismic and leases and costs incurred in our Gulf of Mexico deepwater area.

Capital expenditures for the remainder of 2006 are forecast to be approximately \$110 million and include:

the completion and development of our 2005 and 2006 discoveries;

the non-discretionary drilling of exploratory wells;

the acquisition of seismic and leases; and

capitalized interest and general and administrative costs.

In addition, we are projecting to spend \$27 million for asset retirement obligations.

**Off-Balance Sheet Arrangements**

In December 2003, we announced the formation of a limited liability company, Medusa Spar LLC, which now owns a 75% undivided ownership interest in the deepwater Spar production facilities on our Medusa Field in the Gulf of Mexico. We contributed a 15% undivided ownership interest in the production facility to Medusa Spar LLC in return for approximately \$25 million in cash and a 10% ownership interest in the LLC. The LLC will earn a tariff based upon production volume throughput from the Medusa area. We are obligated to process our share of production from the Medusa Field and any future discoveries in the area through the Spar production facilities. This arrangement allows us to defer the cost of the Spar production facility over the life of the Medusa Field. Our cash proceeds were used to reduce the balance outstanding under our senior secured credit facility. The LLC used \$83.7 million of cash proceeds from non-recourse financing and a cash contribution by one of the LLC owners to acquire its 75% interest in the Spar. The balance of Medusa Spar LLC is owned by Oceaneering International, Inc. (NYSE:OII) and Murphy Oil Corporation (NYSE:MUR). We are accounting for our 10% ownership interest in the LLC under the equity method.

**Table of Contents****Results of Operations**

The following table sets forth certain unaudited operating information with respect to the Company's oil and gas operations for the periods indicated:

|                                          | <b>Three Months Ended<br/>March 31,</b> |             |
|------------------------------------------|-----------------------------------------|-------------|
|                                          | <b>2006</b>                             | <b>2005</b> |
| Net production :                         |                                         |             |
| Oil (MBbls)                              | 515                                     | 641         |
| Gas (MMcf)                               | 1,950                                   | 2,748       |
| Total production (MMcfe)                 | 5,042                                   | 6,593       |
| Average daily production (MMcfe)         | 56.0                                    | 73.3        |
| Average sales price:                     |                                         |             |
| Oil (Bbls) (a)                           | \$ 53.95                                | \$ 37.46    |
| Gas (Mcf)                                | 9.12                                    | 6.92        |
| Total (Mcfe)                             | 9.04                                    | 6.52        |
| Oil and gas revenues:                    |                                         |             |
| Oil revenue                              | \$ 27,799                               | \$ 24,009   |
| Gas revenue                              | 17,782                                  | 19,003      |
| Total                                    | \$ 45,581                               | \$ 43,012   |
| Oil and gas production costs:            |                                         |             |
| Lease operating expense                  | \$ 5,905                                | \$ 6,536    |
| Additional per Mcfe data:                |                                         |             |
| Sales price                              | \$ 9.04                                 | \$ 6.52     |
| Lease operating expense                  | 1.17                                    | 0.99        |
| Operating margin                         | \$ 7.87                                 | \$ 5.53     |
| Depletion, depreciation and amortization | \$ 2.74                                 | \$ 2.34     |
| General and administrative               | \$ 0.34                                 | \$ 0.26     |

(a) Below is a reconciliation of the average NYMEX price to the average realized sales price per barrel of oil:

|                                            |          |          |
|--------------------------------------------|----------|----------|
| Average NYMEX oil price                    | \$ 63.48 | \$ 49.85 |
| Basis differential and quality adjustments | (7.52)   | (6.33)   |
| Transportation                             | (1.27)   | (1.31)   |
| Hedging                                    | (0.74)   | (4.75)   |
| Average realized oil price                 | \$ 53.95 | \$ 37.46 |

**Table of Contents**

**Comparison of Results of Operations for the Three Months Ended March 31, 2006 and the Three Months Ended March 31, 2005.**

**Oil and Gas Production and Revenues**

Total oil and gas revenues increased 6% to \$45.6 million in the first quarter of 2006 from \$43.0 million in the first quarter of 2005. The increase was due to higher product prices. Total production on an equivalent basis for the first quarter of 2006 decreased by 24% versus the first quarter of 2005.

Gas production during the first quarter of 2006 totaled 2.0 Bcf and generated \$17.8 million in revenues compared to 2.7 Bcf and \$19.0 million in revenues during the same period in 2005. The average gas price after hedging impact for the first quarter of 2006 was \$9.12 per Mcf compared to \$6.92 per Mcf for the same period last year. The decrease in production was primarily due to normal and expected decline in production from our Habanero, High Island Block 119, and Mobile Bay area fields and older properties. The decrease was partially offset by production from our new well at East Cameron 90. In addition, initial production from several of our new discoveries was delayed until the second quarter due to weather and equipment availability.

Oil production during the first quarter of 2006 totaled 515,000 barrels and generated \$27.8 million in revenues compared to 641,000 barrels and \$24.0 million in revenues for the same period in 2005. The average oil price received after hedging impact in the first quarter of 2006 was \$53.95 per barrel compared to \$37.46 per barrel in the first quarter of 2005. The decrease in production for the first quarter of 2006 compared to the first quarter of 2005 was primarily due to normal and expected decline in production from our Habanero Field and older properties.

**Lease Operating Expenses**

Lease operating expenses were \$5.9 million for the three-month period ended March 31, 2006, a decrease of \$600,000 compared to the same period in 2005. The decrease was primarily due to the shut-in of our Main Pass 163 Field after the first quarter of 2005, which became uneconomic and is awaiting plugging and abandonment, and a decrease in through-put charges for Habanero resulting from lower production.

**Depreciation, Depletion and Amortization**

Depreciation, depletion and amortization for the three months ended March 31, 2006 and 2005 was \$13.8 million and \$15.4 million, respectively. The 10% decrease was primarily due to lower production volumes for the first quarter of 2006 compared to the same period last year. The decrease was partially offset by a higher depletion rate.

**Accretion Expense**

Accretion expense for the three-month period ended March 31, 2006 and 2005 of \$1.4 million and \$861,000, respectively, represents accretion of our asset retirement obligations. The increase was due to the addition of plugging and abandonment obligations associated with new discoveries. See Note 8 to the Consolidated Financial Statements.

**Table of Contents**

**General and Administrative**

General and administrative expenses, net of amounts capitalized, were \$1.7 million for both three-month periods ended March 31, 2006 and 2005.

**Interest Expense**

Interest expense decreased by 9% to \$4.1 million during the three months ended March 31, 2006 from \$4.6 million during the three months ended March 31, 2005. This decrease is primarily attributable to an increase in capitalized interest resulting from an increase in our investment in unevaluated properties over the last year due to an increase in our exploration program activities.

**Income Taxes**

Income tax expense was \$6.6 million and \$4.8 million for the three-month periods ended March 31, 2006 and 2005, respectively. The increase was due to an increase in income before income taxes.

**Table of Contents**

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company's revenues are derived from the sale of its crude oil and natural gas production. The prices for oil and gas remain extremely volatile and sometimes experience large fluctuations as a result of relatively small changes in supply, weather conditions, economic conditions and government actions. From time to time, the Company enters into derivative financial instruments to manage oil and gas price risk.

The Company utilizes fixed price swaps, which reduce the Company's exposure to decreases in commodity prices and limit the benefit the Company might otherwise have received from any increases in commodity prices.

The Company utilizes price collars to reduce the risk of changes in oil and gas prices. Under these arrangements, no payments are due by either party so long as the market price is above the floor price and below the ceiling price set in the collar. If the price falls below the floor, the counter-party to the collar pays the difference to the Company, and if the price rises above the ceiling, the counter-party receives the difference from the Company.

Callon has purchased puts as another form of derivative financial instrument which reduces the Company's exposure to decreases in oil and gas prices while allowing realization of the full benefit from any increases in oil and gas prices. If the price falls below the puts, the counter-party pays the difference to the Company.

The Company enters into these various agreements from time to time to reduce the effects of volatile oil and gas prices and does not enter into derivative transactions for speculative purposes. However, certain of the Company's derivative positions may not be designated as hedges for accounting purposes.

See Note 4 to the Consolidated Financial Statements for a description of the Company's outstanding derivative contracts at March 31, 2006. There have been no significant changes in market risks faced by the Company since the end of 2005.

**Item 4. CONTROLS AND PROCEDURES**

Evaluation of Disclosure Controls and Procedures. The Company's principal executive and financial officer has concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)) were effective as of March 31, 2006 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

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

**Table of Contents**

**CALLON PETROLEUM COMPANY  
PART II. OTHER INFORMATION**

**Item 6. EXHIBITS**

**Exhibits**

3. Articles of Incorporation and By-Laws
  - 3.1 Certificate of Incorporation of the Company, as amended (incorporated by reference from Exhibit 3.1 of the Company's Annual Report on Form 10-K for the year ended December 31, 2003 filed March 15, 2004, File No. 001-14039)
  - 3.2 Bylaws of the Company (incorporated by reference from Exhibit 3.2 of the Company's Registration Statement on Form S-4, filed August 4, 1994, Reg. No. 33-82408)
4. Instruments defining the rights of security holders, including indentures
  - 4.1 Specimen Common Stock Certificate (incorporated by reference from Exhibit 4.1 of the Company's Registration Statement on Form S-4, filed August 4, 1994, Reg. No. 33-82408)
  - 4.2 Rights Agreement between Callon Petroleum Company and American Stock Transfer & Trust Company, Rights Agent, dated March 30, 2000 (incorporated by reference from Exhibit 99.1 of the Company's Registration Statement on Form 8-A, filed April 6, 2000, File No. 001- 14039)
  - 4.3 Warrant dated as of June 29, 2001 entitling Duke Capital Partners, LLC to purchase common stock from the Company (incorporated by reference to Exhibit 4.11 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2001, File No. 001-14039)

**Table of Contents**

- 4.4 Form of Warrant entitling certain holders of the Company's 10.125% Senior Subordinated Notes due 2002 to purchase common stock from the Company (incorporated by reference to Exhibit 4.13 of the Company's Form 10-Q for the period ended June 30, 2002, File No. 001-14039)
- 4.5 Form of Warrants dated December 8, 2003 and December 29, 2003 entitling lenders under the Company's \$185 million amended and restated Senior Unsecured Credit Agreement, dated December 23, 2003, to purchase common stock from the Company (incorporated by reference to Exhibit 4.14 of the Company's Annual Report on Form 10-K for the year ended December 31, 2003, File No. 001-14039)
- 4.6 Indenture for the Company's 9.75% Senior Notes due 2010, dated March 15, 2004, between Callon Petroleum Company and American Stock Transfer & Trust Company (incorporated by reference to Exhibit 4.16 of the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2004, File No. 001-14039)
- 10. Material Contracts
  - 10.1 2006 Stock Incentive Plan
- 31. Certifications
  - 31.1 Certification of Chief Executive and Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32. Section 1350 Certifications
  - 32.1 Certification of Chief Executive and Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**Table of Contents**

**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.

**CALLON PETROLEUM COMPANY**

Date: May 8, 2006

By: /s/ Fred L. Callon

Fred L. Callon, President and Chief Executive Officer  
(on behalf of the registrant and as the principal financial officer)

23

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**Table of Contents**

| <b><u>Exhibit Number</u></b> | <b><u>Exhibit Index<br/>Title of Document</u></b>                                                                                                                                                                                                                             |
|------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
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**Table of Contents**

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