CREDO PETROLEUM CORP
Form 10-Q
March 23, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

(Mark One)

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

For the quarterly period ended January 31, 2006

o **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: 0-8877

CREDO PETROLEUM CORPORATION

(Exact name of registrant as specified in its charter)

Colorado	**84-0772991**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
1801 Broadway, Suite 900, Denver, Colorado	**80202**
(Address of principal executive offices)	(Zip Code)

303-297-2200

(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 o No þ

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 Act.)

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, net of treasury stock, as of the latest practicable date.

Date	Class	Outstanding
March 16, 2006	Common stock, $.10 par value	9,205,115

CREDO PETROLEUM CORPORATION AND SUBSIDIARIES
Quarterly Report on Form 10-Q For the Period Ended January 31, 2006
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The terms CREDO , Company , we , our , and us refer to CREDO Petroleum Corporation and its subsidiaries unles
context suggests otherwise.

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CREDO PETROLEUM CORPORATION AND SUBSIDIARIES
Consolidated Balance Sheets

	January 31, 2006 (Unaudited)	October 31, 2005
ASSETS		
Current Assets:		
Cash and cash equivalents	**$ 3,155,000**	$ 1,935,000
Short-term investments	**5,706,000**	5,495,000
Receivables:		
Accrued oil and gas sales	**2,354,000**	2,776,000
Trade	**1,705,000**	1,003,000
Other current assets	**233,000**	245,000
Total current assets	**13,153,000**	11,454,000
Long-term assets:		
Oil and gas properties, at cost, using full cost method:		
Unevaluated oil and gas properties	**4,339,000**	3,452,000
Evaluated oil and gas properties	**38,599,000**	36,121,000
Less: accumulated depreciation, depletion and amortization of oil and gas properties	**(15,730,000)**	(15,022,000)
Net oil and gas properties, at cost, using full cost method	**27,208,000**	24,551,000
Exclusive license agreement, net of amortization of $379,000 in 2006 and $361,000 in 2005	**320,000**	338,000
Inventory	**1,097,000**	1,288,000
Other assets	**220,000**	213,000
Total assets	**$ 41,998,000**	$ 37,844,000
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable and accrued liabilities	**$ 4,769,000**	$ 3,426,000
Income taxes payable	**420,000**	331,000
Total current liabilities	**5,189,000**	3,757,000
Long Term Liabilities:		
Deferred income taxes, net	**6,395,000**	5,978,000
Exclusive license obligation, less current obligations of $64,000 in 2006 and 2005	**233,000**	233,000

Asset retirement obligation	**901,000**	929,000
Total liabilities	**12,718,000**	10,897,000
Commitments		
Stockholders Equity:		
Preferred stock, no par value, 5,000,000 shares authorized, none issued		
Common stock, $.10 par value, 20,000,000 shares authorized, 9,510,000 shares issued in 2006 and 2005	**951,000**	951,000
Capital in excess of par value	**14,140,000**	13,933,000
Treasury stock, 347,000 shares in 2006 and 393,000 in 2005		(125,000)
Accumulated other comprehensive income (loss)		(306,000)
Retained earnings, net of $6,272,000 related to 20% stock dividend in 2003	**14,189,000**	12,494,000
Total stockholders equity	**29,280,000**	26,947,000
Total liabilities and stockholders equity	**$ 41,998,000**	$ 37,844,000

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

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CREDO PETROLEUM CORPORATION AND SUBSIDIARIES
Consolidated Statements of Operations
(Unaudited)

	Three Months Ended January 31,	
	2006	2005
REVENUES:		
Oil and gas sales	**$ 4,120,000**	$ 2,385,000
Operating	**173,000**	159,000
Investment income and other	**245,000**	62,000
	4,538,000	2,606,000
COSTS AND EXPENSES:		
Oil and gas production	**1,004,000**	488,000
Depreciation, depletion and amortization	**738,000**	477,000
General and administrative	**433,000**	443,000
Interest	**9,000**	9,000
	2,184,000	1,417,000
INCOME BEFORE INCOME TAXES	**2,354,000**	1,189,000
INCOME TAXES	**(659,000)**	(333,000)
NET INCOME	**$ 1,695,000**	$ 856,000
EARNINGS PER SHARE OF COMMON STOCK BASIC	**$ .19**	$ .09
EARNINGS PER SHARE OF COMMON STOCK DILUTED	**$ .18**	$ .09
Weighted average number of shares of Common Stock and dilutive securities:		
Basic	**9,137,000**	9,056,000
Diluted	**9,475,000**	9,249,000

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

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CREDO PETROLEUM CORPORATION AND SUBSIDIARIES
Statement of Stockholders Equity and Comprehensive Income (Loss)
(Unaudited)
For the Three Months Ended January 31, 2006

	Common Stock		Capital In Excess Of	Treasury	Accumulated Other Comprehensive Income	Comprehensive	Retained	Total Stockholders
	Shares	Amount	Par Value	Stock	(Loss)	Income	Earnings	Equity
Balance, October 31, 2005	9,510,000	$ 951,000	$ 13,933,000	$ (125,000)	$ (306,000)		$ 12,494,000	$ 26,947,000
Comprehensive income:								
Net income						$ 1,695,000	1,695,000	1,695,000
Other comprehensive income:								
Change in fair value of derivatives, net of tax					306,000	306,000		306,000
Total comprehensive income						$ 2,001,000		
Exercise of common stock options			147,000	125,000				272,000
Compensation expense associated with unvested portion of previously granted stock options			60,000					60,000
Balance, January 31, 2006	9,510,000	$ 951,000	$ 14,140,000	$	$		$ 14,189,000	$ 29,280,000

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

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CREDO PETROLEUM CORPORATION AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(Unaudited)

	Three Months Ended January 31,	
	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	**$ 1,695,000**	$ 856,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion and amortization	**738,000**	477,000
Deferred income taxes	**417,000**	385,000
Compensation expense related to stock options granted	**60,000**	53,000
Other		30,000
Changes in operating assets and liabilities:		
Proceeds from short-term investments	**193,000**	1,317,000
Purchase of short-term investments	**(404,000)**	(354,000)
Accrued oil and gas sales	**422,000**	363,000
Trade receivables	**(702,000)**	221,000
Other current assets	**318,000**	(192,000)
Accounts payable and accrued liabilities	**1,343,000**	(102,000)
Income taxes payable	**89,000**	(12,000)
NET CASH PROVIDED BY OPERATING ACTIVITIES	**4,169,000**	3,042,000
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to oil and gas properties	**(3,539,000)**	(2,343,000)
Proceeds from sale of oil and gas properties	**146,000**	
Changes in other long-term assets	**172,000**	(34,000)
NET CASH USED IN INVESTING ACTIVITIES	**(3,221,000)**	(2,377,000)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options	**272,000**	
Purchase of treasury stock		(8,000)
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	**272,000**	(8,000)
INCREASE IN CASH AND CASH EQUIVALENTS	**1,220,000**	657,000
CASH AND CASH EQUIVALENTS:		
Beginning of period	**1,935,000**	518,000

End of period	**$ 3,155,000**	$ 1,175,000
Supplemental cash flow information:		
Cash paid during the period for income taxes	**$ 240,000**	$
Cash paid during the period for interest	**$**	$

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

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CREDO PETROLEUM CORPORATION AND SUBSIDIARIES
Notes To Consolidated Financial Statements (Unaudited)
January 31, 2006

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with U. S. generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U. S. generally accepted accounting principles for complete financial statements. In the opinion of management, the consolidated financial statements contain all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the company s results for the periods presented. These consolidated financial statements should be read in conjunction with the company s Annual Report on Form 10-K for the fiscal year ended October 31, 2005.

The company effected a three-for-two stock split in the third fiscal quarter of 2005. All share and per share amounts discussed and disclosed in this Quarterly Report on Form 10-Q reflect the effect of that stock split.

2. SIGNIFICANT ACCOUNTING POLICIES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The company bases its estimates on historical experience and on various other assumptions it believes to be reasonable under the circumstances. Although actual results may differ from these estimates under different assumptions or conditions, the company believes that its estimates are reasonable and that actual results will not vary significantly from the estimated amounts.

3. STOCK-BASED COMPENSATION

The company currently has one stock-based employee compensation plan, which is described in the Notes to Consolidated Financial Statements in the company s Annual Report on Form 10-K for the year ended October 31, 2005. Prior to November 1, 2005, the company accounted for this plan under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, as permitted by Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*. No stock-based employee compensation expense was recognized in the company s Consolidated Statement of Operations prior to November 1, 2005, as all options granted under the company s stock-based compensation plan had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective November 1, 2005, the company adopted the fair value recognition provisions of SFAS No. 123 (R), *Share Based Payment*, using the modified-retrospective-transition method. Under this transition method, the company restated the results of all prior periods back to the beginning of fiscal 1997 (the fiscal year of inception for this stock-based compensation plan) in accordance with the original provisions of SFAS No. 123. The cumulative effect of this restatement was an increase of $1,447,000 to capital in excess of par value and a decrease to retained earnings in the same amount. For the three months ended January 31, 2006 and 2005, the company recognized compensation expense related to its stock option plan of $60,000 and $53,000, respectively. The company has not made any option grants during fiscal 2006. If option grants are made in the future, compensation expense for all such share-based payments granted, based upon the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R) will also be included in compensation expense.

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4. NATURAL GAS PRICE HEDGING

The company periodically hedges the price of a portion of its estimated natural gas production when the potential for significant downward price movement is anticipated. Hedging transactions typically take the form of forward short positions and collars on the NYMEX futures market, and are closed by purchasing offsetting positions. Such hedges, which are accounted for as cash flow hedges, do not exceed estimated production volumes, are expected to have reasonable correlation between price movements in the futures market and the cash markets where the company s production is located, and are authorized by the company s Board of Directors. Hedges are expected to be closed as related production occurs but may be closed earlier if the anticipated downward price movement occurs or if the company believes that the potential for such movement has abated.

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

Hedging gains and losses are recognized as adjustments to gas sales as the hedged product is produced. The company had after tax hedging losses of $191,000 in the first fiscal quarter of 2006 and after tax hedging losses of $163,000 for the same period in 2005. Any hedge ineffectiveness, which was not material for the first fiscal quarter of 2006, is immediately recognized in gas sales. The company currently has no open hedge positions.

The company has a hedging line of credit with its bank which is available, at the discretion of the company, to meet margin calls. To date, the company has not used this facility and maintains it only as a precaution related to possible margin calls. The maximum credit line is $2,000,000 with interest calculated at the prime rate. The facility is unsecured and requires the company to maintain $3,000,000 in cash or short term investments and prohibits unfunded debt in excess of $500,000. It expires on October 31, 2006.

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5. COMPREHENSIVE INCOME

Comprehensive income includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. The components of comprehensive income for the three months ended January 31, 2006 and 2005 are as follows:

	Three Months Ended January 31,	
	2006	2005
Net income	**$ 1,695,000**	$ 856,000
Other comprehensive income:		
Change in fair value of derivatives	**425,000**	606,000
Income tax expense	**(119,000)**	(177,000)
Total comprehensive income	**$ 2,001,000**	$ 1,285,000

6. EARNINGS PER SHARE

The company s calculation of earnings per share of common stock is as follows:

	Three Months Ended January 31,					
	2006			2005		
	Net Income	**Shares**	**Net Income Per Share**	Net Income	Shares	Net Income Per Share
Basic earnings per share	**$ 1,695,000**	**9,137,000**	**$ .19**	$ 856,000	9,056,000	$ .09
Effect of dilutive shares of common stock from stock options		**338,000**	**(.01)**		193,000	
Diluted earnings per share	**$ 1,695,000**	**9,475,000**	**$ .18**	$ 856,000	9,249,000	$ .09

7. INCOME TAXES

The company uses the asset and liability method of accounting for deferred income taxes. Deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities. Deferred tax assets or liabilities at the end of each period are determined using the tax rate in effect at that time.

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

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8. COMMITMENTS

Effective January 1, 2005, the company entered into an exploration agreement to generate and market gas drilling prospects in South Texas. The company is currently committed to spend $1,900,000 over two years primarily for seismic, leases and administrative costs. Through January 31, 2006, the company has made payments of $1,470,000 towards this commitment. In general, all costs incurred by the company are allocated over a number of prospects, and payout is calculated on a prospect by prospect basis based on recovery of the cost allocated to each prospect. The company owns 75% of each generated prospect before payout and 37.5% after payout. The company has the option to participate in each prospect for all, or a portion, of its interest. If the company does not participate for the full interest, the remaining amount will be sold to industry participants on a promoted basis. Drilling of generated prospects is not covered by the agreement. The company s drilling cost, if any, will depend upon its election to participate with, or sell, all or a portion of its interest in any prospect generated.

In April 2005, the company committed approximately $1,200,000 over an expected two-year period to purchase a 30% interest in 18,000 gross acres along the Central Kansas Uplift, in Graham and Sheridan counties, Kansas, participate in a 3-D seismic survey, and drill five exploratory wells. Through January 31, 2006, the company has made payments of $700,000 towards this commitment. Subsequent drilling will be determined by results from the initial wells. Approximately 28 square miles of proprietary 3-D seismic will be shot to define Lansing-Kansas City oil prospects at about 4,000 feet.

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

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q includes certain statements that may be deemed to be forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements included in this Quarterly Report on Form 10-Q, other than statements of historical facts, address matters that the company reasonably expects, believes or anticipates will or may occur in the future. Forward-looking statements may relate to, among other things:

- the company s future financial position, including working capital and anticipated cash flow;
- amounts and nature of future capital expenditures;
- operating costs and other expenses;
- wells to be drilled or reworked;
- oil and natural gas prices and demand;
- existing fields, wells and prospects;
- diversification of exploration;
- estimates of proved oil and natural gas reserves;
- reserve potential;
- development and drilling potential;
- expansion and other development trends in the oil and natural gas industry;
- the company s business strategy;

production of oil and natural gas;

matters related to the Calliope Gas Recovery System;

effects of federal, state and local regulation;

insurance coverage;

employee relations;

investment strategy and risk; and

expansion and growth of the company s business and operations.

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LIQUIDITY AND CAPITAL RESOURCES

At January 31, 2006, working capital was $7,964,000, compared to $6,305,000 at January 31, 2005. For the three months ended January 31, 2006, net cash provided by operating activities increased $1,127,000, or 37% to $4,169,000 when compared to net cash provided by operating activities of $3,042,000 for the same period in 2005. This increase is primarily the result of increases in net income and other non-cash items of $1,109,000; a net increase of $211,000 in short term investments in 2006 versus a net decrease in short term investments of $963,000 in 2005 which resulted in a net decrease in cash provided by operating activities of $1,174,000 between the two periods; a net decrease in cash provided by operating activities as a result of changes in accrued oil and gas sales, trade receivables and other current assets of $354,000; and a net increase in cash provided by operating activities as a result of changes in accounts payable and income taxes payable of $1,546,000. For the three months ended January 31, 2006 and 2005, net cash used in investing activities was $3,221,000 and $2,377,000, respectively. Investing activities primarily included oil and gas exploration and development expenditures, including Calliope, totaling $3,539,000 and $2,343,000, respectively.

The average return on the company s investments for the three months ended January 31, 2006 and 2005 was 3.2% and 1.0%, respectively. At January 31, 2006, approximately 55% of the investments were directly invested in mutual funds and were managed by professional money managers. Remaining investments are in managed partnerships that use various strategies to minimize their correlation to stock market movements. Most of the investments are highly liquid and the company believes they represent a responsible approach to cash management. In the company s opinion, the greatest investment risk is the potential for negative market impact from unexpected, major adverse news.

Existing working capital and anticipated cash flow are expected to be sufficient to fund operations and capital commitments for at least the next 12 months. As discussed in Note 8 to the consolidated financial statements, at January 31, 2006 the company had remaining commitments of $930,000 related to projects in South Texas and along the Central Kansas uplift. Such costs, which include overhead, lease bonuses, land services and 3-D seismic, are expected to be funded over the next 9 to 12 months. At January 31, 2006, the company had no lines of credit or other bank financing arrangements except for the hedging line of credit discussed in Note 4. Because earnings are anticipated to be reinvested in operations, cash dividends are not expected to be paid. The company has no defined benefit plans and no obligations for post retirement employee benefits.

OFF-BALANCE SHEET FINANCING

The company has no off-balance sheet financing arrangements at January 31, 2006.

PRODUCT PRICES AND PRODUCTION

Although product prices are key to the company s ability to operate profitably and to budget capital expenditures, they are beyond the company s control and are difficult to predict. Since 1991, the company has periodically hedged the price of a portion of its estimated natural gas production when the potential for significant downward price movement is anticipated. Hedging transactions typically take the form of forward short positions and collars on the NYMEX futures market, and are closed by purchasing offsetting positions. Such hedges, which are accounted for as cash flow hedges, do not exceed estimated production volumes, are expected to have reasonable correlation between price movements in the futures market and the cash markets where the company s production is located, and are authorized by the company s Board of Directors. Hedges are expected to be closed as related production occurs but may be closed earlier if the anticipated downward price movement occurs or if the company believes that the potential for such movement has abated. Refer to Note 4 to the Consolidated Financial Statements for a complete discussion on the company s hedging activities.

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Gas and oil sales volume and price realization comparisons for the indicated periods are set forth below. Price realizations include the sales price and hedging losses.

	Three Months Ended January 31,					
	2006		2005		% Change	
Product	**Volume**	**Price**	Volume	Price	Volume	Price
Gas (Mcf)	**437,000**	**$8.19(1)**	&			