PETROHAWK ENERGY CORP
Form 10-Q
November 05, 2009
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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 September 30, 2009

Commission file number 001-33334

PETROHAWK ENERGY CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**86-0876964**
(State or other jurisdiction of	**(I.R.S. Employer**

incorporation or organization)	**Identification Number)**

1000 Louisiana, Suite 5600, Houston, Texas 77002

(Address of principal executive offices including ZIP code)

(832) 204-2700

(Registrant s telephone number)

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

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

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

Indicate by check mark whether the registrant (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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.:

Large accelerated filer x		Accelerated filer	¨
Non-accelerated filer ¨	(Do not check if a smaller reporting company)	Smaller reporting company	¨

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

As of October 30, 2009 the Registrant had 300,847,010 shares of Common Stock, $.001 par value, outstanding.

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Special note regarding forward-looking statements

This report on Form 10-Q contains forward-looking statements within the meaning of the federal securities laws. All statements, other than statements of historical facts, concerning, among other things, planned capital expenditures, potential increases in oil and natural gas production, the number of anticipated wells to be drilled in the future, future cash flows and borrowings, pursuit of potential acquisition opportunities, our financial position, business strategy and other plans and objectives for future operations, are forward-looking statements. These forward-looking statements are identified by their use of terms and phrases such as may, expect, estimate, project, plan, believe, intend, achievable, will, continue, potential, should, could and similar terms and phrases. Although we believe that the expectations reflected in these forward-looking statements are reasonable, they do involve certain assumptions, risks and uncertainties. The actual results could differ materially from those anticipated in these forward-looking statements. One should consider carefully the statements under the Risk Factors section of this report and other sections of this report, as well as those described in our Form 10-K, as amended for the year ended December 31, 2008, which describe factors that could cause our actual results to differ from those set forth in the forward-looking statements, including, but not limited to, the following factors:

- our ability to successfully develop our large inventory of undeveloped acreage primarily held in resource-style areas in Louisiana, Arkansas and Texas, including our resource-style plays such as the Haynesville, Fayetteville and Eagle Ford Shales;
- the volatility in commodity prices for oil and natural gas, including continued declines in prices;
- the possibility that the industry may be subject to future regulatory or legislative actions (including any additional taxes and changes in environmental regulation);
- the presence or recoverability of estimated oil and natural gas reserves and the actual future production rates and associated costs;
- the possibility that production decline rates in some of our resource-style plays are greater than we expect;
- our ability to generate sufficient cash flow from operations, borrowings or other sources to enable us to fully develop our undeveloped acreage positions;
- our ability to replace oil and natural gas reserves;
- environmental risks;
- drilling and operating risks;
- exploration and development risks;
- competition, including competition for acreage in resource-style areas;

management s ability to execute our plans to meet our goals;

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

our ability to obtain goods and services, such as drilling rigs and tubulars, and access to adequate gathering systems and pipeline take-away capacity, to support our drilling program;

our ability to secure firm transportation for natural gas we produce and to sell natural gas at market prices;

general economic conditions, whether internationally, nationally or in the regional and local market areas in which we do business, may be less favorable than expected, including the possibility that the current economic recession and credit crisis in the United States will be severe and prolonged, which could adversely affect the demand for oil and natural gas and make it difficult to access financial markets;

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

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

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

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PART I. FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements (unaudited)

PETROHAWK ENERGY CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Operating revenues:				
Oil and natural gas	$ 174,783	$ 304,960	$ 512,528	$ 824,531
Marketing	63,155		216,165	
Total operating revenues	237,938	304,960	728,693	824,531
Operating expenses:				
Marketing	66,586		211,722	
Production:				
Lease operating	20,788	12,324	55,903	37,621
Workover and other	865	1,696	1,793	3,482
Taxes other than income	15,204	12,185	39,921	37,185
Gathering, transportation and other	22,743	12,489	65,870	32,956
General and administrative	24,550	18,996	68,181	52,364
Depletion, depreciation and amortization	91,692	99,400	290,383	269,221
Full cost ceiling impairment			1,732,486	
Total operating expenses	242,428	157,090	2,466,259	432,829
(Loss) income from operations	(4,490)	147,870	(1,737,566)	391,702
Other (expenses) income:				
Net (loss) gain on derivative contracts	(1,568)	388,216	196,360	(32,130)
Interest expense and other	(58,981)	(40,018)	(170,929)	(102,709)
Total other (expenses) income	(60,549)	348,198	25,431	(134,839)
(Loss) income before income taxes	(65,039)	496,068	(1,712,135)	256,863
Income tax benefit (provision)	24,862	(190,603)	650,201	(99,776)
Net (loss) income available to common stockholders	$ (40,177)	$ 305,465	$ (1,061,934)	$ 157,087
Net (loss) income per share of common stock:				
Basic	$ (0.14)	$ 1.30	$ (3.88)	$ 0.75
Diluted	$ (0.14)	$ 1.28	$ (3.88)	$ 0.74
Weighted average shares outstanding:				
Basic	287,913	235,235	273,477	208,549

Diluted	287,913	239,479	273,477	212,503

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

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PETROHAWK ENERGY CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)

(In thousands, except share and per share amounts)

	September 30, 2009	December 31, 2008
Current assets:		
Cash	$ 1,692	$ 6,883
Marketable securities	150,028	123,009
Accounts receivable	181,915	277,349
Receivables from derivative contracts	150,346	201,128
Prepaids and other	42,079	40,063
Total current assets	526,060	648,432
Oil and natural gas properties (full cost method):		
Evaluated	5,947,489	4,894,357
Unevaluated	2,332,134	2,287,968
Gross oil and natural gas properties	8,279,623	7,182,325
Less - accumulated depletion	(4,122,596)	(2,111,038)
Net oil and natural gas properties	4,157,027	5,071,287
Other operating property and equipment:		
Gas gathering system and equipment	448,596	190,054
Other operating assets	24,301	20,271
Gross other operating property and equipment	472,897	210,325
Less - accumulated depreciation	(21,347)	(11,106)
Net other operating property and equipment	451,550	199,219
Other noncurrent assets:		
Goodwill	932,802	933,058
Other intangible assets	103,266	
Deferred income taxes	173,037	
Debt issuance costs, net of amortization	36,586	30,477
Receivables from derivative contracts	24,589	23,399
Other	2,551	1,457
Total assets	$ 6,407,468	$ 6,907,329
Current liabilities:		
Accounts payable and accrued liabilities	$ 610,496	$ 639,432
Deferred income taxes	42,976	77,454
Liabilities from derivative contracts	363	
Long-term debt	39,821	9,426
Total current liabilities	693,656	726,312

Long-term debt	2,394,270	2,283,874
Other noncurrent liabilities:		
Liabilities from derivative contracts	1,237	
Asset retirement obligations	31,660	28,644
Deferred income taxes		460,913
Other	4,235	2,676
Commitments and contingencies (Note 7)		
Stockholders equity:		
Common stock: 500,000,000 and 300,000,000 shares of $.001 par value authorized at September 30, 2009 and December 31, 2008, respectively; 300,846,264 and 252,364,143 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively	301	252
Additional paid-in capital	4,594,885	3,655,500
Accumulated deficit	(1,312,776)	(250,842)
Total stockholders equity	3,282,410	3,404,910
Total liabilities and stockholders equity	$ 6,407,468	$ 6,907,329

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

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PETROHAWK ENERGY CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(In thousands)

	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Cash flows from operating activities:		
Net (loss) income	$ (1,061,934)	$ 157,087
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depletion, depreciation and amortization	290,383	269,221
Full cost ceiling impairment	1,732,486	
Income tax (benefit) provision	(650,201)	99,776
Stock-based compensation	10,762	9,068
Net unrealized loss (gain) on derivative contracts	96,752	(57,337)
Other	15,926	2,292
Change in assets and liabilities:		
Accounts receivable	91,571	(82,561)
Prepaids and other	(2,016)	1,948
Accounts payable and accrued liabilities	(49,448)	123,369
Other	469	2,921
Net cash provided by operating activities	474,750	525,784
Cash flows from investing activities:		
Oil and natural gas capital expenditures	(1,164,392)	(2,545,944)
Proceeds received from sale of oil and natural gas properties	724	107,324
Marketable securities purchased	(1,282,601)	(2,151,077)
Marketable securities redeemed	1,255,582	1,898,358
Decrease in restricted cash		269,837
Other operating property and equipment expenditures	(225,322)	(75,525)
Other intangible assets acquired	(105,108)	
Other	37,600	
Net cash used in investing activities	(1,483,517)	(2,497,027)
Cash flows from financing activities:		
Proceeds from exercise of options and warrants	2,667	10,770
Proceeds from issuance of common stock	956,500	1,831,951
Offering costs	(30,727)	(73,754)
Proceeds from borrowings	937,674	1,964,000
Repayment of borrowings	(849,513)	(1,736,266)
Debt issue costs	(13,025)	(23,391)
Net cash provided by financing activities	1,003,576	1,973,310
Net (decrease) increase in cash	(5,191)	2,067
Cash at beginning of period	6,883	1,812
Cash at end of period	$ 1,692	$ 3,879

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

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PETROHAWK ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. FINANCIAL STATEMENT PRESENTATION

During interim periods, Petrohawk Energy Corporation (referred to as Petrohawk or the Company) follows the accounting policies disclosed in its 2008 Annual Report on Form 10-K, as amended, and filed with the Securities and Exchange Commission (SEC). Please refer to the footnotes in the 2008 Form 10-K when reviewing interim financial results.

These unaudited condensed consolidated financial statements reflect, in the opinion of the Company s management, all adjustments, consisting only of normal and recurring adjustments, necessary to present fairly the financial position as of, and results of operations for, the periods presented. Condensed consolidated interim period results are not necessarily indicative of results of operations or cash flows for the full year and accordingly, certain information normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States has been condensed or omitted. Certain prior year amounts have been reclassified to conform to the current year presentation. We have evaluated events or transactions through November 4, 2009 in conjunction with the preparation of these condensed consolidated financial statements.

Marketable Securities

The Company invests a portion of its cash in money market mutual funds which are highly liquid marketable securities. The Company accounts for marketable securities in accordance with Financial Accounting Standards Board s (FASB) Accounting Standards Codification (ASC) 320, *Investments Debt and Equity Securities* and classifies marketable securities as trading, available-for-sale, or held-to-maturity. The appropriate classification of its marketable securities is determined at the time of purchase and reevaluated at each balance sheet date.

At September 30, 2009 and December 31, 2008, the Company held approximately $150.0 million and $123.0 million, respectively of marketable securities which have been classified and accounted for as trading securities. Trading securities are recorded at fair value with realized gains and losses reported in *Interest expense and other* in the condensed consolidated statements of operations.

Oil and Natural Gas Properties

The Company accounts for its oil and natural gas producing activities using the full cost method of accounting as prescribed by the SEC. Accordingly, all costs incurred in the acquisition, exploration, and development of proved oil and natural gas properties, including the costs of abandoned properties, dry holes, geophysical costs, and annual lease rentals are capitalized. All general and administrative corporate costs unrelated to drilling activities are expensed as incurred. Sales or other dispositions of oil and natural gas properties are accounted for as adjustments to capitalized costs, with no gain or loss recorded unless the ratio of cost to proved reserves would significantly change. Depletion of evaluated oil and natural gas properties is computed on the units of production method based on proved reserves. The net capitalized costs of proved oil and natural gas properties are subject to a full cost ceiling limitation in which the costs are not allowed to exceed their related estimated future net revenues discounted at 10%, net of tax considerations. Under ASC 932, *Extractive Activities-Oil and Gas*, the Company may utilize the prices in effect on a date subsequent to the end of a reporting period when the full cost ceiling limitation was exceeded at the end of a reporting period and subsequent pricing exceeds pricing at the end of the reporting period. This option will no longer be available to the Company starting December 31, 2009 due to adoption of the new oil and gas reporting requirements as described below under *Recently Issued Accounting Pronouncements.*

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Costs associated with unevaluated properties are excluded from the full cost pool until the Company has made a determination as to the existence of proved reserves. The Company reviews its unevaluated properties at the end of each quarter to determine whether the costs incurred should be transferred to the full cost pool and thereby subject to amortization.

Marketing Revenue and Expense

During the fourth quarter of 2008, a subsidiary of the Company began purchasing and selling third party natural gas produced from wells it operates. The revenues and expenses related to these marketing activities are reported on a gross basis as part of operating revenues and operating expenses. Marketing revenues are recorded at the time natural gas is physically delivered to third parties at a fixed or index price. Marketing expenses attributable to gas purchases are recorded as the Company takes physical title to natural gas and transports the purchased volumes to the point of sale.

Risk Management Activities

The Company follows ASC 815, *Derivatives and Hedging*. From time to time, the Company may hedge a portion of its forecasted oil and natural gas production. Derivative contracts entered into by the Company have consisted of transactions in which the Company hedges the variability of cash flow related to a forecasted transaction. The Company has elected to not designate any of its positions for hedge accounting. Accordingly, the Company records the net change in the mark-to-market valuation of these positions, as well as payments and receipts on settled contracts, in *Net (loss) gain on derivative contracts* on the condensed consolidated statements of operations.

Goodwill

Goodwill represents the excess of the purchase price over the estimated fair value of the assets acquired net of the fair value of liabilities assumed in an acquisition. ASC 350, *Intangibles - Goodwill and Other (ASC 350)* requires that intangible assets with indefinite lives, including goodwill, be evaluated on an annual basis for impairment or more frequently if an event occurs or circumstances change that could potentially result in impairment. The goodwill impairment test requires the allocation of goodwill and all other assets and liabilities to reporting units. If the fair value of the reporting unit is less than the book value (including goodwill), then goodwill is reduced to its implied fair value and the amount of the write-down is charged against earnings. The assumptions used by the Company in calculating its reporting unit fair value at the time of the test include the Company s market capitalization and discounted future cash flows based on estimated reserves and production, future costs and future oil and natural gas prices. Adverse changes to any of these factors could lead to an impairment of all or a portion of the Company s goodwill in future periods.

As a result of full cost ceiling impairments recorded by the Company for the year ended December 31, 2008 and the quarter ended March 31, 2009, the Company reviewed its goodwill for impairment as of March 31, 2009 and December 31, 2008. The Company completed its annual goodwill impairment test during the third quarter of 2009. Based on these reviews, no goodwill impairments were deemed necessary.

Other Intangible Assets

The Company treats the costs associated with acquired transportation contracts as intangible assets. The initial amount recorded represents the fair value of the contract at the time of acquisition, which is amortized under a straight-line method over the life of the contract. Any unamortized balance of the Company s intangible assets will be subject to impairment testing pursuant to the *Impairment or Disposal of Long-Lived Assets Subsections* of ASC Subtopic 360-10.

On July 31, 2009, the Company purchased all outstanding membership interests in Kaiser Trading, LLC (Kaiser) for approximately $105 million. Kaiser s only assets were transportation-related contracts including a firm transportation contract, interruptible gas transportation service agreement, parking and lending services agreement, and a pooling services agreement. The initial firm transportation contract runs through 2013 and at no additional cost, the Company has the contractual right to extend firm supply through 2019. The purchase price has been allocated to the transportation contract which will be amortized on a straight line basis over the life of the extended agreement. Amortization expense was $1.8 million for the period from acquisition through September 30, 2009 and was allocated between *Marketing expenses* and *Gathering, transportation and other* on the condensed consolidated statements of operations based on the usage of the contract. The estimated amortization expense for 2009 will be approximately $4.6 million and approximately $11.1 million per year for the remainder of the contract.

Intangible assets subject to amortization at September 30, 2009 are as follows:

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
		(In thousands)	
Balance at September 30, 2009:			
Transportation contracts	$ 105,108	$ (1,842)	$ 103,266
	$ 105,108	$ (1,842)	$ 103,266

Recently Issued Accounting Pronouncements

In August 2009, the FASB issued Update No. 2009-05, *Fair Value Measurements and Disclosures* (ASU 2009-05). ASU 2009-05 amends Subtopic 820-10, *Fair Value Measurements and Disclosures*, to provide guidance on the fair value measurement of liabilities. ASU 2009-05 provides clarification for circumstances in which a quoted price in an active market for the identical liability is not available. ASU 2009-05 is effective for interim and annual periods beginning after August 26, 2009. The Company is currently assessing the impact that the adoption of ASU 2009-05 will have on the Company s disclosures, operating results, financial position and cash flows.

In June 2009, the FASB issued Update No. 2009-01, *Generally Accepted Accounting Principles* (ASU 2009-01). ASU 2009-01 establishes The FASB Accounting Standards Codification, or Codification, which became the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities. On the effective date, the Codification superseded all then-existing non-SEC accounting and reporting standards. All other nongrandfathered non-SEC accounting literature not included in the Codification will become nonauthoritative. ASU 2009-01 is effective for interim and annual periods ending after September 15, 2009. The Company adopted the provisions of ASU 2009-01 for the period ended September 30, 2009. There was no impact on the Company s operating results, financial position or cash flows.

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events* (ASC 855) to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. ASC 855 is effective for interim and annual reporting periods ending after June 15, 2009. The Company adopted the provisions of ASC 855 for the period ended June 30, 2009. There was no impact on the Company s operating results, financial position or cash flows.

In April 2009, the FASB issued FASB Staff Position (FSP) No. FAS 107-1 and Accounting Principles Board (APB) 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (ASC 825-10-65) to change the reporting requirements on certain fair value disclosures of financial instruments to include interim reporting periods. The Company adopted ASC 825-10-65 in the second quarter of 2009. There was no impact on the Company s operating results, financial position or cash flows; however additional disclosures were added to the accompanying notes to the condensed consolidated financial statements for the Company s fair value of financial instruments. See Note 5 *Fair Value Measurements* for more details.

In April 2009, the FASB *issued FSP No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments*, (ASC 320-10-65), to expand other-than-temporary impairment guidance for debt

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securities to enhance the application of the guidance and improve the presentation and disclosure of other-than temporary impairments on debt and equity securities within the financial statements. The adoption of ASC 320-10-65 in the second quarter of 2009 did not have a significant impact on the Company s operating results, financial position or cash flows.

In April 2009, the FASB issued FSP No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, (ASC 820-10-65) to provide additional guidance for estimating fair value when the volume and level of activity for an asset or liability has significantly decreased. In addition, ASC 820-10-65 includes guidance on identifying circumstances that indicate a transaction is not orderly. The adoption of ASC 820-10-65 in the second quarter of 2009 did not have a significant impact on the Company s operating results, financial position or cash flows.

In December 2008, the SEC issued Release No. 33-8995, Modernization of Oil and Gas Reporting, which amends the oil and gas disclosures for oil and gas producers contained in Regulations S-K and S-X, as well as adding a section to Regulation S-K (Subpart 1200) to codify the revised disclosure requirements in Securities Act Industry Guide 2, which is being phased out. The goal of Release No. 33-8995 is to provide investors with a more meaningful and comprehensive understanding of oil and gas reserves. Energy companies affected by Release No. 33-8995 will be required to price proved oil and gas reserves using the unweighted arithmetic average of the price on the first day of each month within the 12-month period prior to the end of the reporting period, unless prices are defined by contractual arrangements, excluding escalations based on future conditions. SEC Release No. 33-8995 is effective beginning January 1, 2010. The Company is currently evaluating what impact Release No. 33-8995 may have on its financial position, results of operations or cash flows.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133* (ASC 815-10-65). ASC 815-10-65 requires entities that utilize derivative contracts to provide qualitative disclosures about their objectives and strategies for using such instruments, as well as any details of credit-risk-related contingent features contained within derivatives. ASC 815-10-65 also requires entities to disclose additional information about the amounts and location of derivatives located within the financial statements, how the provisions of ASC 815 have been applied, and the impact that hedges have on an entity s operating results, financial position or cash flows. The Company adopted ASC 815-10-65 on January 1, 2009. There was no impact on the Company s operating results, financial position or cash flows; however additional disclosures were added to the accompanying notes to the condensed consolidated financial statements for the Company s derivative contracts. See Note 8 *Derivatives* for more details.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations* (ASC 805), and SFAS No. 160, *Accounting and Reporting of Noncontrolling Interest in Consolidated Financial Statements, an amendment of ARB No. 51* (ASC 810-10-65). ASC 805 and ASC 810-10-65 significantly change the accounting for and reporting of business combination transactions and noncontrolling (minority) interests within the financial statements. ASC 805 provides additional definitions, such as the definition of the acquirer in a purchase and improvements in the application of how the acquisition method is applied. ASC 810-10-65 changes the accounting and reporting for minority interests, which are re-characterized as non-controlling interests, and classified as a component of equity. The Company adopted ASC 805 and ASC 810-10-65 on January 1, 2009. There was no impact on the Company s operating results, financial position or cash flows; however if the Company enters into future business combinations, certain transaction related expenses may be recorded within the Company s operating results which could reduce its current period net income or increase its net loss. Additionally, valuation of certain assets may be different than under the old accounting standards.

Effective January 1, 2009, the Company adopted FSP No. FAS 157-2, *Effective Date of FASB Statement No. 157* (ASC 820-10-55). ASC 820-10-55 delayed the effective date of ASC 820 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of fiscal 2009. These include goodwill and other non-amortizable intangible assets as well as asset retirement obligations. The adoption of ASC 820-10-55 did not have a significant impact on the Company s operating results, financial position or cash flows. See Note 6 *Asset Retirement Obligations* for more details.

In June 2008, the FASB issued FSP No. Emerging Issues Task Force (EITF) 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (ASC 260). ASC 260 clarifies that share-based payment awards that entitle their holders to receive non-forfeitable dividends or dividend equivalents before vesting should be considered participating securities. The adoption of ASC 260 on January 1, 2009 did not have a significant impact on the Company s operating results, financial position or cash flows.

2. ACQUISITIONS AND DIVESTITURES

Acquisitions

Fayetteville Shale

On January 7, 2008, the Company entered into an agreement to purchase additional properties located in the Fayetteville Shale for $231.3 million after customary closing adjustments. The transaction closed on February 8, 2008. The acquired properties include interests primarily in Van Buren and Cleburne Counties, Arkansas that are substantially undeveloped.

Elm Grove Field

On January 22, 2008, the Company completed an acquisition of interests in the Elm Grove Field, located primarily in Bossier and Caddo Parishes of North Louisiana, for approximately $169 million.

Divestitures

Gulf Coast Properties

On November 30, 2007, the Company completed the sale of its Gulf Coast properties for $825 million, consisting of $700 million in cash and a $125 million note that the purchaser could redeem at any time prior to one year from November 30, 2007 for $100 million plus accrued and unpaid interest. If the redemption occurred prior to April 29, 2008, accrued interest would be waived. On April 28, 2008, the purchaser redeemed the note for $100 million.

3. OIL AND NATURAL GAS PROPERTIES

The Company uses the full cost method of accounting for its investment in oil and natural gas properties. Under this method of accounting, all costs of acquisition, exploration and development of oil and natural gas reserves (including such costs as leasehold acquisition costs, geological expenditures, dry hole costs, tangible and intangible development costs and direct internal costs) are capitalized as the cost of oil and natural gas properties when incurred. To the extent capitalized costs of evaluated oil and natural gas properties, net of accumulated depletion exceed the discounted future net revenues of proved oil and natural gas reserves net of deferred taxes, such excess capitalized costs are charged to expense. Full cost companies use the prices in effect at the end of each accounting quarter to calculate the ceiling test value of their reserves. Subsequent commodity price increases may be utilized to calculate the ceiling value and reserves. However, this option will no longer be available to the Company starting December 31, 2009 due to adoption of the new oil and natural gas reporting requirements.

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The Company assesses all items classified as unevaluated property on a quarterly basis for possible impairment or reduction in value. The Company assesses properties on an individual basis or as a group if properties are individually insignificant. The assessment includes consideration of the following factors, among others: intent to drill; remaining lease term; geological and geophysical evaluations; drilling results and activity; the assignment of proved reserves; and the economic viability of development if proved reserves are assigned. During any period in which these factors indicate an impairment, the cumulative drilling costs incurred to date for such property and all or a portion of the associated leasehold costs are transferred to the full cost pool and are then subject to amortization.

At September 30, 2009, the ceiling test value of the Company s reserves was calculated based on the September 30, 2009 West Texas Intermediate (WTI) posted price of $70.61 per barrel, adjusted by lease for quality, transportation fees, and regional price differentials, and the September 30, 2009 Henry Hub spot market price of $3.30 per million British thermal units (Mmbtu), adjusted by lease for energy content, transportation fees, and regional price differentials. At September 30, 2009, the Company s net book value of oil and natural gas properties exceeded the ceiling amount by approximately $880 million before tax, $546 million after tax. However, subsequent to September 30, 2009, the market price for Henry Hub gas and West Texas Intermediate oil increased significantly. As a consequence, prior to October 28, 2009, the Company elected to use prices on October 28, 2009, which were a WTI price of $77.20 per barrel and a Henry Hub spot market price of $4.51 per Mmbtu, adjusted for certain items as previously discussed. Utilizing these prices, the Company s net book value of oil and natural gas properties at September 30, 2009, would not have exceeded the ceiling amount. As a result of the increase in the ceiling amount using the subsequent prices, the Company did not record a write-down of its oil and natural gas property costs. Changes in production rates, levels of reserves, future development costs, and other factors will determine the Company s actual ceiling test calculation and impairment analyses in future periods.

At March 31, 2009 the ceiling test value of the Company s reserves was calculated based on the March 31, 2009 WTI posted price of $49.66 per barrel, adjusted by lease for quality, transportation fees, and regional price differentials, and the March 31, 2009 Henry Hub spot market price of $3.63 per Mmbtu, adjusted by lease for energy content, transportation fees, and regional price differentials. Using these prices, the Company s net book value of oil and natural gas properties exceeded the ceiling amount by approximately $1.7 billion before tax, $1.1 billion after tax. Accordingly, the Company recorded an approximate $1.7 billion full cost ceiling impairment at March 31, 2009, before tax.

At December 31, 2008, the ceiling test value of the Company s reserves was calculated based on the December 31, 2008 WTI posted price of $41.00 per barrel, adjusted by lease for quality, transportation fees, and regional price differentials, and the December 31, 2008, Henry Hub spot market price of $5.71 per Mmbtu, adjusted by lease for energy content, transportation fees, and regional price differentials. At December 31, 2008, the Company s net book value of oil and natural gas properties exceeded the ceiling amount by approximately $1.0 billion before tax, and $574 million after tax. Accordingly, the Company recorded approximately $1.0 billion in full cost ceiling impairments at December 31, 2008, before tax.

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4. LONG-TERM DEBT

Long-term debt as of September 30, 2009 and December 31, 2008 consisted of the following:

	September 30, 2009[(1)]	December 31, 2008[(1)]
	(In thousands)	
Senior revolving credit facility	$	$ 450,000
10.5% $600 million senior notes [(2)]	552,337	
7.875% $800 million senior notes	800,000	800,000
9.125% $775 million senior notes [(3)]	764,456	763,773
7.125% $275 million senior notes [(4)]	265,804	264,080
9.875% senior notes	224	254
Deferred premiums on derivatives	11,449	5,767
	$ 2,394,270	$ 2,283,874

(1) Amount excludes $39.8 million and $9.4 million of long-term debt which has been classified as current at September 30, 2009 and December 31, 2008, respectively. These amounts represent deferred premiums on derivatives contracts that are expected to be settled in the next 12 months.

(2) Amount includes a $47.7 million discount at September 30, 2009 recorded by the Company in conjunction with the issuance of the notes. See 10.5% Senior Notes below for more details.

(3) This amount is comprised of the $650.0 million and $125.0 million private placements consummated in July 2006. These amounts include a $5.1 million and $5.9 million discount at September 30, 2009 and December 31, 2008, respectively, recorded by the Company in conjunction with the issuance of the $650.0 million notes. Additionally, these amounts include a $0.8 and $1.0 million premium at September 30, 2009 and December 31, 2008, recorded by the Company in conjunction with the issuance of the $125.0 million notes. See 9.125% Senior Notes below for more details.

(4) Amount includes a $6.6 million and $8.3 million discount at September 30, 2009 and December 31, 2008, respectively, recorded by the Company in conjunction with the assumption of the notes. See 7.125% Senior Notes below for more details.

Senior Revolving Credit Facility

The Company entered into the Third Amended and Restated Senior Revolving Credit Agreement, dated as of September 10, 2008 (the Senior Credit Agreement), between the Company, each of the lenders from time to time party thereto (the Lenders), BNP Paribas, as administrative agent for the Lenders, Bank of America, N.A. and BMO Capital Markets Financing, Inc. as co-syndication agents for the Lenders, and JPMorgan Chase Bank, N.A., Wells Fargo Bank, N.A. and Fortis Capital Corp. as co-documentation agents for the Lenders, which amends and restates its $1 billion senior revolving credit agreement dated July 12, 2006. The Senior Credit Agreement provides for a $1.5 billion facility with a borrowing base of $1.1 billion that will be redetermined on a semi-annual basis, with the Company and the Lenders each having the right to one annual interim unscheduled redetermination, and adjusted based on the Company s oil and natural gas properties, reserves, other indebtedness and other relevant factors. The Company s borrowing base is subject to a reduction equal to the product of $0.25 multiplied by the stated principal amount (without regard to any initial issue discount) of any notes that the Company may issue. On January 27, 2009, the Company completed a private placement offering to eligible purchasers of an aggregate principal amount of $600 million 10.5% senior notes due August 1, 2014. In conjunction with the closing of this offering, the Company s borrowing base was reduced to $950 million.

Amounts outstanding under the Senior Credit Agreement will bear interest at specified margins over the London Interbank Offered Rate (LIBOR) of 1.25% to 2.00% for Eurodollar loans or at specified margins over the Alternate Base Rate (ABR) of 0.00% to 0.50% for ABR loans. Such margins will fluctuate based on the utilization of the facility. Borrowings under the Senior Credit Agreement may be secured by first priority liens on

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substantially all of the Company s assets, including pursuant to the terms of the Third Amended and Restated Guarantee and Collateral Agreement, substantially all of the assets of, and all equity interests in, the Company s subsidiaries. Amounts drawn down on the facility will mature on July 1, 2013.

The Senior Credit Agreement contains financial and other covenants, including minimum working capital levels (the ratio of current assets plus the unused commitment under the Senior Credit Agreement to current liabilities) of not less than 1.0 to 1.0 and minimum coverage of interest expenses of not less than 2.5 to 1.0. In addition, the Company is subject to covenants limiting dividends and other restricted payments, transactions with affiliates, incurrence of debt, changes of control, asset sales, and liens on properties. At September 30, 2009, the Company was in compliance with all of its debt covenants under the Senior Credit Agreement.

On October 14, 2009, the Company entered into the Fourth Amended and Restated Senior Revolving Credit Agreement (the Fourth Amendment), which amends and restates its Senior Credit Agreement. The Fourth Amendment is a $2.0 billion facility with a borrowing base of $1.5 billion, $1.2 billion of which relates to the Company s oil and natural gas properties and up to $300 million (currently limited as described below) of which relates to the Company s midstream assets. The portion of the borrowing base which relates to the Company s oil and natural gas properties will be redetermined on a semi-annual basis (with the Company and the Lenders each having the right to one annual interim unscheduled redetermination) and adjusted based on the Company s oil and natural gas properties, reserves, other indebtedness and other relevant factors. The component of the borrowing base related to the Company s midstream assets is limited to the lesser of $300 million or 3.5 times midstream EBITDA, and is determined quarterly. The initial available borrowing base aggregates $1.38 billion as the midstream component is currently $182 million. Amounts outstanding under the Fourth Amendment will bear interest at specified margins over LIBOR of 2.25% to 3.25% for Eurodollar loans or at specified margins over the ABR of 0.75% to 1.75% for ABR loans. Such margins will fluctuate based on the utilization of the facility. Borrowings under the Fourth Amendment will be secured by first priority liens on substantially all of the Company s assets, including pursuant to the terms of the Fourth Amended and Restated Guarantee and Collateral Agreement, all of the assets of, and equity interests in, the Company s subsidiaries. Amounts drawn down on the facility will mature on July 1, 2013. On October 30, 2009, in conjunction with the closing of the sale of the Company s Permian Basin properties, the oil and natural gas properties portion of the borrowing base under the Fourth Amendment was reduced by $200 million to $1 billion, resulting in a new aggregate borrowing base of $1.18 billion, including the Company s midstream assets allocation. Please refer to Note 12, *Subsequent Events*, for further information.

10.5% Senior Notes

On January 27, 2009, the Company completed a private placement offering to eligible purchasers of an aggregate principal amount of $600 million principal amount of its 10.5% senior notes due August 1, 2014 (the 2014 Notes). The 2014 Notes were issued under and are governed by an indenture dated January 27, 2009, between the Company, U.S. Bank Trust National Association, as trustee, and the Company s subsidiaries named therein as guarantors (the 2014 Indenture). The 2014 Notes were priced at 91.279% of the face value to yield 12.7% to maturity. Net proceeds from the offering were used to repay all outstanding borrowings on the Company s Senior Credit Agreement.

The 2014 Notes bear interest at a rate of 10.5% per annum, payable semi-annually on February 1 and August 1 of each year, commencing August 1, 2009. The 2014 notes will mature on August 1, 2014. The 2014 Notes are senior unsecured obligations of the Company and rank equally with all of its current and future senior indebtedness. The 2014 Notes are jointly and severally guaranteed on a senior unsecured basis by the Company s subsidiaries. Petrohawk Energy Corporation, the issuer of the 2014 Notes, has no material independent assets or operations apart from the assets and operations of its subsidiaries.

On or before February 1, 2012, the Company may redeem up to 35% of the aggregate principal amount of the 2014 Notes with the net cash proceeds of certain equity offerings at a redemption price of 110.5% of the principal amount plus accrued interest and unpaid interest to the redemption date provided that at least 65% in aggregate principal amount of the 2014 Notes originally issued under the 2014 Indenture remain outstanding immediately after the redemption. In addition, at any time prior to February 1, 2012, the Company may redeem some or all of the 2014 Notes for the principal amount thereof, plus accrued and unpaid interest plus a make

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whole premium equal to the excess, if any of (a) the present value at such time of (i) the redemption price of such note at February 1, 2012, (ii) plus required interest payments due on the notes, computed using a discount rate based upon the yield of U.S. Treasury securities with a constant maturity most nearly equal to the period from the redemption date to February 1, 2012 plus 50 basis points, over (b) the principal amount of such note.

On or after February 1, 2012, the Company may redeem some or all of the 2014 Notes at any time or from time to time at the redemption prices (expressed as a percentage of principal amount) set forth in the following table plus accrued and unpaid interest, if any, to the applicable redemption date, if redeemed during the 12-month period beginning February 1 of the years indicated below:

Year	Percentage
2012	110.500
2013	105.250
2014	100.000

The Company may be required to offer to repurchase the 2014 Notes at a purchase price of 101% of the principal amount, plus accrued and unpaid interest, if any, to the redemption date, in the event of a change of control as defined in the 2014 Indenture. The 2014 Indenture contains covenants that, among other things, restrict or limit the ability of the Company and its subsidiaries to: borrow money; pay dividends on stock; purchase or redeem stock or subordinated indebtedness; make investments; create liens; enter into transactions with affiliates; sell assets; and merge with or into other companies or transfer all or substantially all of the Company s assets. At September 30, 2009, the Company was in compliance with all of its debt covenants relating to the 2014 Notes.

In conjunction with the issuance of the $600 million 2014 Notes, the Company recorded a discount of $52.3 million to be amortized over the remaining life of the notes utilizing the effective interest rate method. The remaining unamortized discount was $47.7 million at September 30, 2009.

7.875% Senior Notes

On May 13, 2008 and June 19, 2008, the Company issued $500 million principal amount and $300 million principal amount, respectively, of its 7.875% senior notes due 2015 (the 2015 Notes). The 2015 Notes were issued under and are governed by an indenture dated May 13, 2008, between the Company, U.S. Bank Trust National Association, as trustee, and the Company s subsidiaries named therein as guarantors.

The 2015 Notes bear interest at a rate of 7.875% per annum, payable semi-annually on June 1 and December 1 of each year, commencing December 1, 2008. The 2015 Notes will mature on June 1, 2015. The 2015 Notes are senior unsecured obligations of the Company and rank equally with all of its current and future senior indebtedness. The 2015 Notes are jointly and severally guaranteed on a senior unsecured basis by the Company s subsidiaries. Petrohawk Energy Corporation, the issuer of the 2015 Notes, has no material independent assets or operations apart from the assets and operations of its subsidiaries. At September 30, 2009, the Company is in compliance with all of its debt covenants relating to the 2015 Notes.

9.125% Senior Notes

In July 2006, the Company consummated its private placement of 9.125% Senior Notes, also referred to as the 2013 Notes, pursuant to an Indenture dated as of July 12, 2006 (2013 Indenture) and the First Supplemental Indenture to the 2013 Notes (the 2013 First Supplemental Indenture), among the Company, the Company s subsidiaries named therein as guarantors, and U.S. Bank National Association, as trustee. The 2013 Notes were issued at 98.735% of the face amount.

The 2013 Notes bear interest at the rate of 9.125% per annum, payable semi-annually on January 15 and July 15 of each year, commencing January 15, 2007. The 2013 Notes mature on July 15, 2013. The 2013 Notes are senior unsecured obligations of the Company and rank equally with all of its current and future senior

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indebtedness, including the 2012 Notes. The 2013 Notes rank effectively subordinate to the Company s secured debt to the extent of the collateral, including secured debt under the Senior Credit Agreement, and senior to any future subordinated indebtedness. The 2013 Notes are jointly and severally guaranteed on a senior unsecured basis by the Company s subsidiaries, including, pursuant to the 2013 First Supplemental Indenture, the KCS Energy, Inc. (KCS) subsidiaries acquired in the Company s merger with KCS. Petrohawk Energy Corporation, the issuer of the 2013 Notes, has no material independent assets or operations apart from the assets and operations of its subsidiaries. At September 30, 2009, the Company was in compliance with all of its debt covenants relating to the 2013 Notes.

In conjunction with the issuance of the $650 million 2013 Notes, the Company recorded a discount of $8.2 million to be amortized over the remaining life of the notes utilizing the effective interest rate method. The remaining unamortized discount was $5.1 million at September 30, 2009. In conjunction with the issuance of the $125 million 2013 Notes, the Company recorded a premium of $1.4 million to be amortized over the remaining life of the notes utilizing the effective interest rate method. The remaining unamortized premium was $0.8 million at September 30, 2009.

7.125% Senior Notes

On July 12, 2006, the date of the Company s merger with KCS, the Company assumed (pursuant to the Second Supplemental Indenture relating to the 7.125% Senior Notes, also referred to as the 2012 Notes), and subsidiaries of the Company guaranteed (pursuant to the Third Supplemental Indenture relating to such notes), all the obligations (approximately $275 million) of KCS under the 2012 Notes and the Indenture dated April 1, 2004 (the 2012 Indenture) among KCS, U.S. Bank National Association, as trustee, and the subsidiary guarantors named therein, which governs the terms of the 2012 Notes. The 2012 Notes are guaranteed on an unsubordinated, unsecured basis by all of the Company s current subsidiaries, including the subsidiaries of KCS that the Company acquired in the merger. Interest on the 2012 Notes is payable semi-annually, on each April 1 and October 1. The 2012 Notes are jointly and severally guaranteed on a senior unsecured basis by the Company s subsidiaries. Petrohawk Energy Corporation, the issuer of the Notes, has no material independent assets or operations apart from the assets and operations of its subsidiaries. At September 30, 2009, the Company was in compliance with all of its debt covenants under the 7.125% Senior Notes.

In conjunction with the assumption of the 7.125% Senior Notes from KCS, the Company recorded a discount of $13.6 million to be amortized over the remaining life of the notes utilizing the effective interest rate method. The remaining unamortized discount is $6.6 million at September 30, 2009.

9.875% Senior Notes

On April 8, 2004, Mission Resources Corporation (Mission) issued $130.0 million of its 9.875% senior notes due 2011 (the 2011 Notes). The Company assumed these notes upon the closing of the Company s merger with Mission. In conjunction with the Company s merger with KCS, the Company redeemed substantially all of its 2011 Notes for face value plus a premium of $14.9 million and accrued interest of $3.5 million. There were approximately $0.2 million of the notes which were not redeemed and are still outstanding as of September 30, 2009. In connection with the extinguishment of substantially all of the 2011 Notes, the Company requested and received from the noteholders consent to eliminate the debt covenants associated with the 2011 Notes.

Debt Issuance Costs

The Company capitalizes certain direct costs associated with the issuance of long-term debt. The Company capitalized $23.8 million of debt issue costs in connection with the Company s issuance of 2015 Notes in May and June 2008 and in connection with the Company s amended and restated senior revolving credit facility in September 2008. The Company capitalized $13.2 million with its issuance of the 2014 Notes in January 2009. In the first quarter of 2009, the Company wrote off $0.9 million of debt issuance costs as a result of the 2014 Notes issuance and from the reduction of our Senior Credit Agreement s borrowing base to $950 million. At September 30, 2009 and December 31, 2008, the Company had approximately $36.6 million and $30.5 million, respectively of debt issuance costs remaining that are being amortized over the lives of the respective debt.

5. FAIR VALUE MEASUREMENTS

Effective January 1, 2008, the Company adopted ASC 820. ASC 820 defines fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. Pursuant to ASC 820, the Company s determination of fair value incorporates not only the credit standing of the counterparties involved in transactions with the Company resulting in receivables on the Company s condensed consolidated balance sheets, but also the impact of the Company s nonperformance risk on its liabilities.

ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). The Company utilizes market data or assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable. The Company classifies fair value balances based on the observability of those inputs. ASC 820 establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurement) and the lowest priority to unobservable inputs (level 3 measurement).

The three levels of the fair value hierarchy defined by ASC 820 are as follows:

Level 1 Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide pricing information on an ongoing basis. Level 1 primarily consists of financial instruments such as exchange-traded derivatives, marketable securities and listed equities.

Level 2 Pricing inputs are other than quoted prices in active markets included in level 1, which are either directly or indirectly observable as of the reported date. Level 2 includes those financial instruments that are valued using models or other valuation methodologies. These models are primarily industry-standard models that consider various assumptions, including quoted forward prices for commodities, time value, volatility factors, and current market and contractual prices for the underlying instruments, as well as other relevant economic measures. Substantially all of these assumptions are observable in the marketplace throughout the full term of the instrument, can be derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. Instruments in this category generally include non-exchange-traded derivatives such as commodity swaps, interest rate swaps, options and collars.

Level 3 Pricing inputs include significant inputs that are generally less observable from objective sources. These inputs may be used with internally developed methodologies that result in management s best estimate of fair value.

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The following tables set forth by level within the fair value hierarchy the Company s financial assets and liabilities that were accounted for at fair value as of September 30, 2009 and December 31, 2008. As required by ASC 820, a financial instrument s level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The Company s assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels.

	September 30, 2009			
	Level 1	Level 2 (In thousands)	Level 3	Total
Assets:				
Marketable securities	$ 150,028	$	$	$ 150,028
Receivables from derivative contracts		174,935		174,935
	$ 150,028	$ 174,935	$	$ 324,963
Liabilities:				
Liabilities from derivative contracts	$	$ 1,600	$	$ 1,600
	$	$ 1,600	$	$ 1,600

	December 31, 2008			
	Level 1	Level 2 (In thousands)	Level 3	Total
Assets:				
Marketable securities	$ 123,009	$	$	$ 123,009
Receivables from derivative contracts		224,527		224,527
	$ 123,009	$ 224,527	$	$ 347,536
Liabilities:				
Liabilities from derivative contracts	$	$	$	$
	$	$	$	$

Marketable securities listed above are carried at fair value. The Company is able to value its marketable securities based on quoted fair values for identical instruments, which resulted in the Company reporting its marketable securities as Level 1.

Derivatives listed above include collars, swaps, basis swaps and puts that are carried at fair value. The Company records the net change in the fair value of these positions in *Net (loss) gain on derivative contracts* in the Company s condensed consolidated statements of operations. The Company is able to value the assets and liabilities based on observable market data for similar instruments, which resulted in the Company reporting its derivatives as Level 2. This observable data includes the forward curve for commodity prices based on quoted markets prices and implied volatility factors related to changes in the forward curves.

As of September 30, 2009 and December 31, 2008, the Company s derivative contracts were with major financial institutions with investment grade credit ratings which are believed to have a minimal credit risk. As such, the Company is exposed to credit risk to the extent of nonperformance by the counterparties in the derivative contracts discussed above; however, the Company does not anticipate such nonperformance. Each of the counterparties to the Company s derivative contracts is a lender in the Company s Senior Credit Agreement. The Company did not post collateral under any of these contracts as they are secured under the Senior Credit Agreement.

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of ASC 825-10-65. The estimated fair value amounts have been determined at discrete points in

time based on relevant market information. These estimates involve uncertainties and cannot be determined with precision. The estimated fair value of cash, accounts receivable and accounts payable approximates their carrying value due to their short-term nature. The estimated fair value of the Company s Senior Credit Agreement approximates carrying value because the facility s interest rate approximates current market rates. The following table presents the estimated fair values of the Company s fixed interest rate debt instruments as of September 30, 2009 and December 31, 2008 (excluding premiums and discounts):

	September 30, 2009		December 31, 2008	
Debt	**Carrying Amount**	**Estimated Fair Value**	**Carrying Amount**	**Estimated Fair Value**
		(In thousands)		
10.5% $600 million senior notes	$ 600,000	$ 643,500	$	$
7.875% $800 million senior notes	800,000	800,800	800,000	591,040
9.125% $775 million senior notes	768,725	787,943	768,725	595,762
7.125% $275 million senior notes	272,375	271,694	272,375	223,348
9.875% senior notes	224	228	254	213
	$ 2,441,324	$ 2,504,165	$ 1,841,354	$ 1,410,363

6. ASSET RETIREMENT OBLIGATIONS

The Company records an asset retirement obligation (ARO) when the total depth of a drilled well is reached and the Company can reasonably estimate the fair value of an obligation to perform site reclamation, dismantle facilities or plug and abandon costs. For gas gathering systems, the Company records an ARO when the system is placed in service and the Company can reasonably estimate the fair value of an obligation to perform site reclamation and other necessary work. The Company records the ARO liability on the condensed consolidated balance sheets and capitalizes the cost in *Oil and natural gas properties evaluated* or *Other operating property and equipment - gas gathering system and equipment* during the period in which the obligation is incurred. In general, the amount of an ARO and the costs capitalized will be equal to the estimated future cost to satisfy the abandonment obligation using current prices that are escalated by an assumed inflation factor up to the estimated settlement date and adjusted for the Company s credit risk. This amount is then discounted back to the date that the abandonment obligation was incurred using an assumed cost of funds for the Company. After recording these amounts, the ARO is accreted to its future estimated value using the same assumed cost of funds. The Company records the accretion of its ARO liabilities in *Depletion, depreciation and amortization* expense in the condensed consolidated statements of operations. The additional capitalized costs are depreciated on a unit-of-production basis or straight-line basis.

The Company recorded the following activity related to its ARO liability for the nine months ended September 30, 2009 (in thousands):

Liability for asset retirement obligation as of December 31, 2008	$ 28,644
Liabilities settled and divested	(351)
Additions	2,246
Acquisitions	14
Accretion expense	1,070
Revisions in estimated cash flows	37
Liability for asset retirement obligation as of September 30, 2009	$ 31,660

7. COMMITMENTS AND CONTINGENCIES

From time to time, the Company may be a plaintiff or defendant in a pending or threatened legal proceeding arising in the normal course of its business. All known liabilities are accrued based on the Company s best estimate of the potential loss. While the outcome and impact of currently pending legal proceedings cannot be

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predicted with certainty, the Company s management and legal counsel believe that the resolution of these proceedings through settlement or adverse judgment will not have a material adverse effect on the Company s condensed consolidated operating results, financial position or cash flows. Please refer to Part II. Other Information, Item 1. *Legal Proceedings* for further information on pending cases.

As of September 30, 2009, the Company had drilling rigs under contract with a total commitment of $316.0 million over approximately four years. At December 31, 2008, the Company had drilling rigs under contract with a total commitment of $433.0 million over four years.

The Company has various other contractual commitments pertaining to exploration, development and production activities. The Company has work related commitments for, among other things, pipeline and well equipment, obtaining and processing seismic data and natural gas pipeline transportation. At September 30, 2009 and December 31, 2008, these work related commitments totaled $1.1 billion over 16 years and $507.8 million over 20 years, respectively.

8. DERIVATIVES

The Company is exposed to certain risks relating to its ongoing business operations, such as commodity price risk and interest rate risk. Derivative contracts are utilized to economically hedge its exposure to price fluctuations and reduce the variability in the Company s cash flows associated with anticipated sales on future oil and natural gas production. The Company generally hedges a substantial, but varying, portion of anticipated oil and natural gas production for the next 12-36 months. Derivatives are carried at fair value on the condensed consolidated balance sheets, with the changes in the fair value included in the condensed consolidated statements of operations for the period in which the change occurs. Generally, the Company enters into interest rate swaps to mitigate exposure to market rate fluctuations by converting variable interest rates (such as those on the Company s Senior Credit Agreement) to fixed interest rates.

It is the Company s policy to enter into derivative contracts, including interest rate swaps, only with counterparties that are creditworthy financial institutions deemed by management as competent and competitive market makers. Each of the counterparties to the Company s derivative contracts is a lender in the Company s Senior Credit Agreement. The Company did not post collateral under any of these contracts as they are secured under the Company s Senior Credit Agreement.

At September 30, 2009 the Company has entered into commodity collars, swaps, put options and basis swaps. The Company has elected to not designate any of its derivative contracts for hedge accounting. Accordingly, the Company records the net change in the mark-to-market valuation of these derivative contracts, as well as all payments and receipts on settled derivative contracts, in *Net (loss) gain on derivatives contracts* on the condensed consolidated statements of operations.

During the second quarter of 2009, the Company entered into five interest rate swaps to convert a portion of its long-term debt from a fixed interest rate to a variable interest rate. During the third quarter of 2009, the Company made the decision to settle all of its outstanding interest rate swap positions which resulted in a gain of approximately $5.2 million. This gain is included in *Net (loss) gain on derivatives contracts* on the condensed consolidated statements of operations.

During the first quarter of 2009, the Company entered into three interest rate swap derivative contracts. In conjunction with the issuance of the 2014 Notes in January 2009, the Company repaid all outstanding borrowings under its Senior Credit Agreement. As a result, the Company made the decision to settle all of its outstanding interest rate swap derivative contracts which resulted in a minimal gain during the first quarter of 2009. This gain is included in *Net (loss) gain on derivative contracts* on the condensed consolidated statements of operations.

During the first quarter of 2008, the Company entered into two interest rate swap derivative contracts. In conjunction with the Company s debt and equity raises during the second quarter of 2008, the Company repaid

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all outstanding borrowings under its Senior Credit Agreement. As a result, the Company made the decision to settle all of its outstanding interest rate swap derivative contracts which resulted in a gain of $1.5 million during the second quarter of 2008 which is included in *Net (loss) gain on derivative contracts* on the condensed consolidated statements of operations.

At September 30, 2009, the Company had 95 open commodity derivative contracts summarized in the tables below: 74 natural gas collar arrangements, two natural gas swap arrangements, two natural gas basis swap arrangement, 13 natural gas put options and four crude oil price swap arrangements. Derivative commodity contracts settle based on NYMEX West Texas Intermediate and Henry Hub prices which may differ from the actual price received by the Company for the sale of its oil and natural gas production. The Company s basis swaps hedge the basis differential between NYMEX Henry Hub price and the Houston Ship Channel price.

At December 31, 2008, the Company had 69 open commodity derivative contracts summarized in the tables below: 52 natural gas collar arrangements, two natural gas swap arrangements, one natural gas basis swap arrangement, 10 natural gas put options and four crude oil price swap arrangements.

All derivative contracts are recorded at fair market value in accordance with ASC 815 and ASC 820 and included in the condensed consolidated balance sheets as assets or liabilities. The following table summarizes the location and fair value amounts of all derivative contracts in the condensed consolidated balance sheets as of September 30, 2009 and December 31, 2008:

Derivatives not designated as hedging contracts under ASC 815	**Asset derivative contracts**			**Liability derivative contracts**		
	Balance sheet location	**September 30, 2009**	**December 31, 2008**	**Balance sheet location**	**September 30, 2009**	**December 31, 2008**
		(In thousands)			**(In thousands)**	
Commodity contracts	Current assets - receivables from derivative contracts	$ 150,346	$ 201,128	Current liabilities - liabilities from derivative contracts	$ (363)	$
Commodity contracts	Other noncurrent assets - receivables from derivative contracts	24,589	23,399	Other noncurrent liabilities - liabilities from derivative contracts	(1,237)	
Total derivatives not designated as hedging contracts under ASC 815		$ 174,935	$ 224,527		$ (1,600)	$

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The following table summarizes the location and amounts of the Company s realized and unrealized gains and losses on derivative contracts in the Company s condensed consolidated statements of operations:

Derivatives not designated as hedging contracts under ASC 815	Location of gain or (loss) recognized in income on derivative contracts	Amount of gain or (loss) recognized in income on derivative contracts three months ended September 30, 2009	2008	Amount of gain or (loss) recognized in income on derivative contracts nine months ended September 30, 2009	2008
		(In thousands)			
Commodity contracts:					
Unrealized (loss) gain on commodity contracts	Other (expenses) income - net (loss) gain on derivative contracts	$ (112,891)	$ 423,917	$ (96,752)	$ 57,337
Realized gain (loss) on commodity contracts	Other (expenses) income - net (loss) gain on derivative contracts	108,358	(35,701)	287,579	(90,967)
Total net (loss) gain on commodity contracts		$ (4,533)	$ 388,216	$ 190,827	$ (33,630)
Interest rate swaps:					
Unrealized loss on interest rate swaps	Other (expenses) income - net (loss) gain on derivative contracts	$ (2,280)	$	$	$
Realized gain on interest rate swaps	Other (expenses) income - net (loss) gain on derivative contracts	5,245		5,533	1,500
Total net gain on interest rate swaps		$ 2,965	$	$ 5,533	$ 1,500
Total net (loss) gain on derivative contracts	Other (expenses) income - net (loss) gain on derivative contracts	$ (1,568)	$ 388,216	$ 196,360	$ (32,130)

At September 30, 2009 and December 31, 2008, the Company had the following open derivative contracts:

				September 30, 2009			
				Floors		Ceilings	
Period	Instrument	Commodity	Volume in Mmbtu s / Bbl s	Price / Price Range	Weighted Average Price	Price / Price Range	Weighted Average Price
October 2009 - December 2009 [(1)]	Collars	Natural gas	18,400,000	$ 4.50 - $9.00	$ 7.60	$ 6.69 - $16.45	$ 12.22
October 2009 - December 2009	Swaps	Natural gas	460,000	8.43	8.43		
October 2009 - December 2009	Floor	Natural gas	13,800,000	4.50 - 10.00	6.21		
October 2009 - December 2009	Swaps	Oil	69,000	76.85 -77.30	77.00		
January 2010 - December 2010	Collars	Natural gas	138,700,000	5.00 - 7.00	5.97	9.00 - 10.00	9.21
January 2010 - December 2010	Swaps	Natural gas	1,825,000	8.22	8.22		
January 2010 - December 2010	Floor	Natural gas	7,240,000	4.49 - 4.55	4.54		
January 2010 - December 2010	Swaps	Oil	273,750	75.15 - 75.55	75.28		
January 2011 - December 2011	Collars	Natural gas	125,925,000	5.50 - 6.00	5.57	9.00 - 10.30	10.00

(1) Includes a natural gas collar with a second put option sold at $3.00 for 920,000 Mmbtus during the fourth quarter.

Period	Instrument	Commodity	September 30, 2009

			Volume in Mmbtu s	Price Range	Weighted Average Price
October 2009 - December 2009	Basis swaps	Natural gas	1,840,000	$ 0.33 - $0.34	$ 0.34

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				December 31, 2008			
				Floors		Ceilings	
Period	Instrument	Commodity	Volume in Mmbtu's / Bbl's	Price / Price Range	Weighted Average Price	Price / Price Range	Weighted Average Price
January 2009 - December 2009	Collars	Natural gas	75,730,000	$ 7.00 - $10.00	$ 7.57	$ 9.60 - $16.45	$ 11.79
January 2009 - December 2009	Swaps	Natural gas	1,825,000	8.43	8.43		
January 2009 - December 2009	Floor	Natural gas	14,600,000	10.00	10.00		
January 2009 - December 2009	Swaps	Oil	273,750	76.85 - 77.30	77.00		
January 2010 - December 2010	Collars	Natural gas	29,200,000	7.00	7.00	10.00	10.00
January 2010 - December 2010	Swaps	Natural gas	1,825,000	8.22	8.22		
January 2010 - December 2010	Swaps	Oil	273,750	75.15 - 75.55	75.28		

			December 31, 2008		
Period	Instrument	Commodity	Volume in Mmbtu s	Price / Price Range	Weighted Average Price
January 2009 - December 2009	Basis swaps	Natural gas	3,650,000	$ 0.33	$ 0.33

9. STOCKHOLDERS EQUITY

At the Company s annual meeting on June 18, 2009, its shareholders voted on three proposals related to its common stock and stock plans. The Company s Certificate of Incorporation was amended to increase the number of shares of common stock available for issuance from 300 million shares to 500 million shares. In addition, amendments to the Company s 2004 Employee Incentive Plan and the 2004 Non-Employee Director Incentive Plan were approved to increase the number of shares of common stock that may be issued under the plans by 5.3 million shares and 0.5 million shares, respectively.

On August 11, 2009, the Company sold an aggregate of 25.0 million shares of its common stock in an underwritten public offering. The gross proceeds from the sale were approximately $572 million, before deducting underwriting discounts and commissions and estimated expenses of $22 million.

On March 4, 2009, the Company sold an aggregate of 22.0 million shares of its common stock in an underwritten public offering. The gross proceeds from the sale were approximately $385 million, before deducting underwriting discounts and commissions and estimated expenses of $9 million.

On August 15, 2008, the Company sold an aggregate of 28.8 million shares of its common stock in an underwritten public offering. The gross proceeds from the sale were approximately $763 million, before deducting underwriting discounts and commissions and estimated expenses of $29 million.

On May 13, 2008, the Company sold an aggregate of 25.0 million shares of its common stock in an underwritten public offering. Pursuant to the underwriting agreement, the Company granted the underwriters a 30-day option to purchase up to an additional 3.75 million shares of common stock at the public offering price less underwriting discounts and commissions. The underwriters exercised in full their option to purchase additional shares of common stock which closed on May 23, 2008. The gross proceeds from these sales were approximately $759 million, before deducting underwriting discounts and commissions and estimated expenses of $32 million.

On February 1, 2008, the Company sold an aggregate of 20.7 million shares of its common stock in an underwritten public offering. The gross proceeds from the sale were approximately $311 million, before deducting underwriting discounts and commissions and estimated expenses of $14 million.

Warrants, Options and Stock Appreciation Rights

During the nine months ended September 30, 2009, the Company granted stock options covering 1.6 million shares of common stock to employees of the Company. The stock options have exercise prices ranging from

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$15.23 to $26.12 with a weighted average price of $15.47. These awards vest over a three year period at a rate of one-third on the annual anniversary date of the grant and expire ten years from the grant date. At September 30, 2009, the unrecognized compensation expense related to non-vested stock appreciation rights and stock options totaled $8.6 million and will be recognized on a straight line basis over the weighted average remaining vesting period of 1.2 years.

During the nine months ended September 30, 2008, the Company granted stock options covering 1.1 million shares of common stock to employees of the Company. The stock options have exercise prices ranging from $15.97 to $47.16 with a weighted average price of $19.03. These awards vest over a three year period at a rate of one-third on the annual anniversary date of the grant and expire ten years from the grant date.

During the nine months ended September 30, 2009, there were 0.6 million warrants exercised at a price of $3.30 per share which represented the remaining outstanding warrants granted in conjunction with the recapitalization of the Company by PHAWK, LLC in the second quarter of 2004.

Restricted Stock

During the nine months ended September 30, 2009, the Company granted 0.7 million shares of restricted stock to employees of the Company and non-employee directors. These restricted shares were granted at prices ranging from $15.23 to $26.12 with a weighted average price of $15.81. Employee shares vest over a three-year period at a rate of one-third on the annual anniversary date of the grant and the non-employee directors shares vest six-months from the date of grant. At September 30, 2009, the unrecognized compensation expense related to non-vested restricted stock totaled $10.0 million and was to be recognized on a straight line basis over the weighted average remaining vesting period of 1.2 years.

During the nine months ended September 30, 2008, the Company granted 0.5 million shares of restricted stock to employees of the Company. These restricted shares were granted at prices ranging from $15.97 to $48.30 with a weighted average price of $19.04. Employee shares vest over a three-year period at a rate of one-third on the annual anniversary date of the grant and the non-employee directors shares vest six-months from the date of grant.

Performance Shares

At December 31, 2008, the performance period related to the plan assumed in the merger between KCS and Petrohawk was completed. The required objectives were met and therefore a total of 0.2 million shares were issued on February 16, 2009. The shares are now held as restricted stock until the restriction lapses on December 31, 2009. The Company recognized $0.4 million in compensation cost for the nine months ended September 30, 2008.

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Assumptions

The assumptions used in calculating the fair value of the Company s stock-based compensation are disclosed in the following table:

	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Weighted average value per option granted during the period	$ 7.23	$ 5.57
Assumptions (1)(2)(3):		
Stock price volatility		