

CALLON PETROLEUM CO

Form 10-Q

May 09, 2008

Table of Contents

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

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

For the Quarterly Period Ended March 31, 2008

Commission File Number 001-14039

CALLON PETROLEUM COMPANY

(Exact name of registrant as specified in its charter)

Delaware

64-0844345

(State or other jurisdiction of
incorporation or organization)

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

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

(Address of principal executive offices)(Zip code)

(601) 442-1601

(Registrant's telephone number,
including area code)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a smaller reporting company)

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

As of May 6, 2008, there were 20,951,352 shares of the Registrant's Common Stock, par value \$0.01 per share, outstanding.

**CALLON PETROLEUM COMPANY
TABLE OF CONTENTS**

| | Page No. |
|---|-----------------|
| Part I. Financial Information | |
| <u>Consolidated Balance Sheets as of March 31, 2008 and December 31, 2007</u> | 3 |
| <u>Consolidated Statements of Operations for the Three Months Ended March 31, 2008 and March 31, 2007</u> | 4 |
| <u>Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2008 and March 31, 2007</u> | 5 |
| <u>Notes to Consolidated Financial Statements</u> | 6 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 12 |
| <u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u> | 19 |
| <u>Item 4. Controls and Procedures</u> | 20 |
| Part II. Other Information | |
| <u>Item 6. Exhibits</u> | 21 |
| <u>Certification of CEO Pursuant to Section 302</u> | |
| <u>Certification of CFO Pursuant to Section 302</u> | |
| <u>Certification of CEO Pursuant to Section 906</u> | |
| <u>Certification of CFO Pursuant to Section 906</u> | |

Table of Contents

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

| | March 31, 2008 (Unaudited) | December 31, 2007 (Note 1) |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 42,312 | \$ 53,250 |
| Accounts receivable | 22,899 | 22,073 |
| Restricted investments | 141 | 100 |
| Other current assets | 1,890 | 6,592 |
| Total current assets | 67,242 | 82,015 |
| Oil and gas properties, full-cost accounting method: | | |
| Evaluated properties | 1,391,964 | 1,349,904 |
| Less accumulated depreciation, depletion and amortization | (753,403) | (738,374) |
| | 638,561 | 611,530 |
| Unevaluated properties excluded from amortization | 61,347 | 70,176 |
| Total oil and gas properties | 699,908 | 681,706 |
| Other property and equipment, net | 2,137 | 1,986 |
| Restricted investments | 4,525 | 4,525 |
| Investment in Medusa Spar LLC | 12,740 | 12,673 |
| Other assets, net | 7,473 | 9,577 |
| Total assets | \$ 794,025 | \$ 792,482 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | \$ 25,096 | \$ 37,698 |
| Asset retirement obligations | 9,470 | 9,810 |
| Fair market value of derivatives | 8,613 | 5,205 |
| Total current liabilities | 43,179 | 52,713 |
| Long-term debt | 392,589 | 392,012 |
| Asset retirement obligations | 27,849 | 27,027 |
| Deferred tax liability | 35,094 | 32,190 |

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| | | |
|---|------------|------------|
| Other long-term liabilities | 2,018 | 1,465 |
| Total liabilities | 500,729 | 505,407 |
| Stockholders' equity: | | |
| Preferred Stock, \$.01 par value, 2,500,000 shares authorized; | | |
| Common Stock, \$.01 par value, 30,000,000 shares authorized; 20,941,779 and | | |
| 20,891,145 shares outstanding at March 31, 2008 and December 31, 2007, | | |
| respectively | 209 | 209 |
| Capital in excess of par value | 224,140 | 223,336 |
| Other comprehensive income | (5,598) | (3,383) |
| Retained earnings | 74,545 | 66,913 |
| Total stockholders' equity | 293,296 | 287,075 |
| Total liabilities and stockholders' equity | \$ 794,025 | \$ 792,482 |

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

Table of Contents

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

| | Three Months Ended | |
|---|---------------------------|-------------|
| | March 31, | |
| | 2008 | 2007 |
| Operating revenues: | | |
| Oil sales | \$ 25,096 | \$ 15,968 |
| Gas sales | 19,864 | 29,516 |
| Total operating revenues | 44,960 | 45,484 |
| Operating expenses: | | |
| Lease operating expenses | 5,178 | 6,599 |
| Depreciation, depletion and amortization | 15,029 | 21,847 |
| General and administrative | 2,652 | 2,221 |
| Accretion expense | 1,032 | 1,112 |
| Total operating expenses | 23,891 | 31,779 |
| Income from operations | 21,069 | 13,705 |
| Other (income) expenses: | | |
| Interest expense | 9,940 | 4,585 |
| Other income | (472) | (325) |
| Total other (income) expenses | 9,468 | 4,260 |
| Income before income taxes | 11,601 | 9,445 |
| Income tax expense | 4,082 | 3,803 |
| Income before equity in earnings of Medusa Spar LLC | 7,519 | 5,642 |
| Equity in earnings of Medusa Spar LLC, net of tax | 113 | 161 |
| Net income | \$ 7,632 | \$ 5,803 |
| Net income per share: | | |
| Basic | \$ 0.37 | \$ 0.28 |
| Diluted | \$ 0.35 | \$ 0.27 |

| | | |
|--|--------|--------|
| Shares used in computing net income per share: | | |
| Basic | 20,871 | 20,722 |
| Diluted | 21,644 | 21,193 |

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

4

Table of Contents

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

| | Three Months Ended | |
|---|---------------------------|------------------|
| | March | March 31, |
| | 31, | 2007 |
| | 2008 | 2007 |
| Cash flows from operating activities: | | |
| Net income | \$ 7,632 | \$ 5,803 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Depreciation, depletion and amortization | 15,213 | 22,039 |
| Accretion expense | 1,032 | 1,112 |
| Amortization of deferred financing costs | 873 | 569 |
| Equity in earnings of Medusa Spar LLC | (113) | (161) |
| Deferred income tax expense | 4,082 | 3,803 |
| Non-cash charge related to compensation plans | 371 | 341 |
| Excess tax benefits from share-based payment arrangements | (47) | |
| Changes in current assets and liabilities: | | |
| Accounts receivable | (648) | 3,407 |
| Other current assets | 4,702 | 917 |
| Current liabilities | (252) | (5,554) |
| Change in gas balancing receivable | 923 | 12 |
| Change in gas balancing payable | 557 | 122 |
| Change in other long-term liabilities | (4) | (3) |
| Change in other assets, net | 810 | 462 |
| Cash provided by operating activities | 35,131 | 32,869 |
| Cash flows from investing activities: | | |
| Capital expenditures | (46,208) | (24,332) |
| Entrada acquisition | | (7,500) |
| Distribution from Medusa Spar LLC | 108 | 186 |
| Cash used by investing activities | (46,100) | (31,646) |
| Cash flows from financing activities: | | |
| Increases in debt | | 11,000 |
| Payments on debt | | (11,000) |
| Equity issued related to employee stock plans | (16) | |
| Excess tax benefits from share-based payment arrangements | 47 | |
| Capital leases | | (55) |
| Cash provided (used) by financing activities | 31 | (55) |

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| | | |
|---|-----------|----------|
| Net decrease in cash and cash equivalents | (10,938) | 1,168 |
| Cash and cash equivalents: | | |
| Balance, beginning of period | 53,250 | 1,896 |
| Balance, end of period | \$ 42,312 | \$ 3,064 |

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

Table of Contents

CALLON PETROLEUM COMPANY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2008

1. General

The financial information presented as of any date other than December 31, 2007 has been prepared from the books and records of Callon Petroleum Company (the Company or Callon) without audit. Financial information as of December 31, 2007 has been derived from the audited financial statements of the Company, but does not include all disclosures required by U.S. generally accepted accounting principles. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, necessary for the fair presentation of the financial information for the periods indicated, have been included. For further information regarding the Company's accounting policies, refer to the Consolidated Financial Statements and related notes for the year ended December 31, 2007 included in the Company's Annual Report on Form 10-K filed March 17, 2008. The results of operations for the three-month period ended March 31, 2008 are not necessarily indicative of future financial results.

2. Net Income Per Share

Basic net income per share was computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted net income per common share was determined on a weighted average basis using common shares issued and outstanding adjusted for the effect of stock options and restricted stock considered common stock equivalents computed using the treasury stock method.

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

| | Three Months Ended March 31, | |
|---|---|-------------|
| | 2008 | 2007 |
| (a) Net income | \$ 7,632 | \$ 5,803 |
| (b) Weighted average shares outstanding | 20,871 | 20,722 |
| Dilutive impact of stock options | 197 | 138 |
| Dilutive impact of warrants | 453 | 298 |
| Dilutive impact of restricted stock | 123 | 35 |
| (c) Weighted average shares outstanding for diluted net income per share | 21,644 | 21,193 |
| Basic net income per share (a,b) | \$ 0.37 | \$ 0.28 |
| Diluted net income per share (a,c) | \$ 0.35 | \$ 0.27 |
| Stock options excluded due to the exercise price being greater than the average stock price | 30 | 104 |

Table of Contents**3. Derivatives**

The Company periodically uses derivative financial instruments to manage oil and gas price risk on a limited amount of its future production and does not use these instruments for trading purposes. Settlements of oil and gas derivative contracts are generally based on the difference between the contract price or prices specified in the derivative instrument and a NYMEX price or other cash or futures index price. Such derivative contracts are accounted for under Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, (SFAS No. 133), as amended.

The Company's derivative contracts that are accounted for as cash flow hedges under SFAS 133 are recorded at fair market value and the changes in fair value are recorded through other comprehensive income (loss), net of tax, in stockholders' equity. The cash settlements on contracts for future production are recorded as an increase or decrease in oil and gas sales. The changes in fair value related to ineffective derivative contracts are recognized as derivative expense (income). The cash settlements on these contracts are also recorded within derivative expense (income).

Cash settlements on effective oil and gas cash flow hedges during the three-month period ended March 31, 2008 resulted in a decrease in oil and gas sales of \$1.8 million. For the three-month period ended March 31, 2007, cash settlements on effective oil and gas cash flow hedges resulted in an increase in oil and gas sales of \$2.8 million.

The Company's derivative contracts are carried at fair value on our consolidated balance sheet under the caption Fair Market Value of Derivatives. The oil and gas derivative contracts are settled based upon reported prices on NYMEX. The estimated fair value of these contracts is based upon closing exchange prices on the NYMEX and in the case of collars and floors, the time value of options. See Note 8, Fair Value Measures.

Listed in the table below are the outstanding oil and gas derivative contracts as of March 31, 2008:

Collars

| Product | Volumes per Month | Quantity Type | Average Floor Price | Average Ceiling Price | Period |
|-------------|-------------------|---------------|---------------------|-----------------------|-------------|
| Oil | 30,000 | Bbls | \$65.00 | \$81.50 | 04/08-12/08 |
| Natural Gas | 175,000 | MMBtu | \$ 7.50 | \$ 9.60 | 04/08-12/08 |
| Natural Gas | 100,000 | MMBtu | \$ 8.00 | \$11.13 | 04/08-12/08 |

Swaps

| Product | Volumes per Month | Quantity Type | Average Price | Period |
|---------|-------------------|---------------|---------------|-------------|
| Oil | 15,000 | Bbls | \$91.00 | 04/08-12/08 |

Table of Contents**4. Long-Term Debt**

Long-term debt consisted of the following at:

| | March 31, 2008 | December 31, 2007 |
|--|-------------------------------|----------------------------------|
| | (In thousands) | |
| Senior Secured Credit Facility (matures July 31, 2010) | \$ | \$ |
| 9.75% Senior Notes (due 2010), net of discount | 192,589 | 192,012 |
| Senior Revolving Credit Facility (due 2014) (1) | 200,000 | 200,000 |
| | | |
| Total long-term debt | \$ 392,589 | \$ 392,012 |

(1) Retired April 8,
2008

On August 30, 2006, the Company closed on a four-year amended and restated senior secured credit facility with the Union Bank of California (UBOC). The borrowing base, which is reviewed and redetermined semi-annually, was \$50 million at March 31, 2008. Borrowings under the credit facility are secured by mortgages covering the Company's major fields. As of March 31, 2008, there were no borrowings under the facility; however Callon had a letter of credit outstanding in the amount of \$15 million to secure a drilling rig for the development of Entrada. As a result, \$35 million was available for future borrowings under the credit facility as of March 31, 2008.

On April 18, 2007, Callon closed the Entrada acquisition contemporaneous with a seven-year \$200 million senior revolving credit facility arranged by Merrill Lynch Capital Corporation, which is secured by a lien on the Entrada properties. Borrowings outstanding under the facility bear interest at a rate of LIBOR plus 7%. The Company borrowed the full commitment amount under the facility at closing to cover the required \$150 million payment to BP Exploration and Production Company (BP) and expenses and fees related to the transaction and the balance was used to pay down the Company's UBOC senior secured credit facility. Callon's UBOC senior secured credit facility was amended to allow for this transaction.

Subsequent to the Balance Sheet date, Callon extinguished the \$200 million senior revolving credit facility, which resulted in prepayment penalties of approximately \$6.6 million. The retirement was made with cash on hand, a \$16 million draw under the UBOC credit facility and proceeds from the sale of a 50% working interest in our Entrada Field to CIECO Energy (US) Limited (CIECO). See Note 7 for more details.

In addition, a wholly-owned subsidiary of Callon, Callon Entrada Company (Callon Entrada), entered into a credit agreement with CIECO Energy (Entrada) LLC, pursuant to which Callon Entrada may borrow up to \$150 million plus interest expense incurred of up to \$12 million to finance the development of the Entrada prospect. The Callon Entrada credit facility is fully collateralized by the Entrada Field. However, Callon has entered into a customary indemnification agreement pursuant to which it agrees to indemnify the lenders under the Callon Entrada credit facility against Callon Entrada's misappropriation of funds, non-performance of certain covenants and similar matters. In addition, Callon also guaranteed the obligations of Callon Entrada to fund its proportionate share of any operating costs related to the Entrada project that Callon Entrada may, from time to time, expressly

Table of Contents

approve under the Entrada joint operating agreement. Callon also has guaranteed all of Callon Entrada's plugging and abandonment obligations, for a breach of law, rule or regulation (including environmental laws) and for any losses attributable to gross negligence of Callon Entrada.

The Callon Entrada credit facility bears interest at six-month LIBOR (as in effect on the first day of each interest period) plus 375 basis points and requires semi-annual payments of principal and interest derived from estimated cash flow from the Entrada project. These payments will begin six months after the date of initial production from the Entrada project. The Callon Entrada credit facility matures within five years of first production from the property, and is subject to customary representations, warranties, covenants and events of default.

5. Comprehensive Income

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

| | Three Months Ended March 31, | |
|-------------------------------------|---|-------------|
| | 2008 | 2007 |
| Net income | \$ 7,632 | \$ 5,803 |
| Other comprehensive income (loss): | | |
| Change in fair value of derivatives | (2,215) | (5,921) |
| Total comprehensive income (loss) | \$ 5,417 | \$ (118) |

6. Asset Retirement Obligations

The following table summarizes the activity for the Company's asset retirement obligations:

| | Three Months Ended March 31, 2008 | |
|---|--|---------|
| Asset retirement obligations at beginning of period | \$ | 36,837 |
| Accretion expense | | 1,032 |
| Liabilities incurred | | 390 |
| Liabilities settled | | (943) |
| Revisions to estimate | | 3 |
| Asset retirement obligations at end of period | | 37,319 |
| Less: current asset retirement obligations | | (9,470) |
| Long-term asset retirement obligations | \$ | 27,849 |

Assets, primarily U.S. Government securities, of approximately \$4.7 million at March 31, 2008, are recorded as restricted investments. These assets are held in abandonment trusts dedicated to pay future abandonment costs for several of the Company's oil and gas properties.

Table of Contents

7. Entrada Divestiture

On April 8, 2008, Callon completed the sale of a 50% working interest in the Entrada Field to CIECO effective January 1, 2008. At closing, CIECO paid Callon \$155 million and reimbursed Callon \$12.6 million for 50% of Entrada capital expenditures incurred prior to the closing date. In addition, CIECO agreed to fund half of a \$40 million future contingent payment owed by Callon to BP Exploration and Production Company, the former majority interest owner of the field. Callon has retained a 50% working interest and will continue as operator of the field. The Company will not recognize a gain or loss on this transaction.

As part of the transaction, an affiliate of CIECO will provide a loan to Callon for \$150 million at LIBOR plus 375 basis points for field development costs through initial production plus capitalized interest of up to \$12 million to finance the development of the Entrada prospect. See Note 4 for more details.

Contemporaneous with the Entrada divestiture, the Company retired the \$200 million senior revolving credit facility arranged by Merrill Lynch Capital Corporation, which resulted in prepayment penalties of approximately \$6.6 million. The retirement was made with the proceeds from the divestiture, cash on hand and a draw of \$16 million on the UBOC credit facility.

8. Fair Value Measurements

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards No. 157, (SFAS 157), Fair Value Measurements. SFAS 157 defines fair value, establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements. The Company also adopted Statement of Financial Accounting Standards No. 159, (SFAS 159), The Fair Value Option for Financial Assets and Financial Liabilities, on January 1, 2008, which permits entities to choose to measure various financial instruments and certain other items at fair value. SFAS 157 establishes a fair value hierarchy which consists of three broad levels that prioritize the inputs to valuation techniques used to measure fair value.

Level 1 valuations consists of unadjusted quoted prices in active markets for identical assets and liabilities and has the highest priority.

Level 2 valuations rely on quoted market information for the calculation of fair market value.

Level 3 valuations are internal estimates and have the lowest priority.

Per SFAS 157, the Company has classified its derivatives into these levels depending upon the data relied on to determine the fair values. The fair values of collars and natural gas basis swaps are estimated using internal discounted cash flow calculations based upon forward commodity price curves or quotes obtained from counterparties to the agreements and are designated as Level 3. The following table summarizes the valuation of our assets and liabilities measured at fair value on a recurring basis at March 31, 2008 (in thousands):

Table of Contents

| | Quoted Prices in Active Markets (Level 1) | Fair Value Measurements Using Significant | | |
|------------------------|---|--|--|---|
| | | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Assets (Liabilities) At Fair Value |
| Derivative assets | \$ | \$ | \$ | \$ |
| Derivative liabilities | | | (8,613) | (8,613) |
| Total | \$ | \$ | \$ (8,613) | \$ (8,613) |

The table below presents a reconciliation for assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the first quarter of 2008. The fair values of Level 3 derivative instruments are estimated using proprietary valuation models that utilize both market observable and unobservable parameters. Level 3 instruments presented in the table consist of net derivatives valued using pricing models incorporating assumptions that, in management's judgment, reflect the assumptions a marketplace participant would have used at March 31, 2008 (in thousands):

| | |
|---|---------------------------|
| Balance at January 1, 2008 | Derivatives \$ (5,205) |
| Total gains or losses (realized or unrealized): | |
| Included in earnings | |
| Included in other comprehensive income (loss) | (5,243) |
| Purchases, issuances and settlements | 1,835 |
| Balance at March 31, 2008 | \$ (8,613) |
| Change in unrealized gains (losses) included in earnings relating to derivatives still held as of March 31, 2008 | \$ |

9. Accounting Pronouncements

In March 2008, FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133 (FASB 161), was issued. FASB 161 changes the disclosure requirements for derivative instruments and hedging activities. Under FASB 161, entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The new disclosure standard is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The Statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption.

Table of Contents

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

Forward-Looking Statements

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

General

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

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

Table of Contents

Liquidity and Capital Resources

Our primary sources of capital are cash flows from operations, borrowings from financial institutions and the sale of debt and equity securities. On March 31, 2008, we had cash and cash equivalents of \$42.3 million and \$35 million of availability under our UBOC senior secured credit facility. Cash provided from operating activities during the three-month period ended March 31, 2008 totaled \$35 million, a 7% increase when compared to 2007.

On April 8, 2008, we completed the sale of a 50% working interest in the Entrada Field to CIECO Energy (US) Limited (CIECO), a subsidiary of Tokyo-based ITOCHU Corporation. At closing, CIECO paid \$155 million and reimbursed us \$12.6 million for 50% of Entrada capital development expenditures incurred prior to the closing date. In addition, CIECO agreed to fund half of a \$40 million future contingent payment owed by us to BP Exploration and Production Company, the former majority interest owner of the field. We have retained a 50% working interest and will continue as operator of the field. We will not recognize a gain or loss on the transaction.

In addition, a wholly-owned subsidiary of Callon, Callon Entrada Company (Callon Entrada), entered into a credit agreement with CIECO Energy (Entrada) LLC, pursuant to which Callon Entrada may borrow up to \$150 million plus interest expense incurred of up to \$12 million to finance the development of the Entrada prospect. The Callon Entrada credit facility is fully collateralized by the Entrada Field. However, we have entered into a customary indemnification agreement pursuant to which we agree to indemnify the lenders under the Callon Entrada credit facility against Callon Entrada's misappropriation of funds, non-performance of certain covenants and similar matters. In addition, we also guaranteed the obligations of Callon Entrada to fund its proportionate operating cost related to the Entrada project that Callon Entrada may, from time to time, expressly approve under the Entrada joint operating agreement. We also guaranteed all of Callon Entrada's plugging and abandonment obligations, for a breach of law, rule or regulation (including environmental laws) and for any losses attributable to gross negligence of Callon Entrada.

The Callon Entrada credit facility bears interest at six-month LIBOR (as in effect on the first day of each interest period) plus 375 basis points and requires semi-annual payments of principal and interest derived from estimated cash flow from the Entrada project. These payments will begin six months after the date of initial production from the Entrada project. The Callon Entrada credit facility matures within five years of first production from the property, and is subject to customary representations, warranties, covenants and events of default.

Simultaneously with the closing of the CIECO transaction, we used the proceeds from the sale, cash on hand and a draw of \$16 million from our UBOC credit facility, to extinguish the \$200 million senior secured revolving credit facility, which resulted in prepayment penalties of approximately \$6.6 million. The revolving credit facility was secured by a lien on the Entrada properties.

For 2008, our capital expenditure budget is comprised of the development of our Entrada Field, which is our major focus for the year, plus a limited exploration and development program. Our approved budget for the Entrada development project is \$300 million, of which 50% will be our share. Of this gross amount, we expect to incur approximately 80%, or \$240 million, of development costs during 2008. Our credit agreement with CIECO Energy (Entrada) LLC will finance our 50% share of the development costs.

Table of Contents

Our remaining capital expenditure budget for 2008, excluding our Entrada Field development, will require approximately \$71 million of funding, which includes asset retirement obligations, capitalized interest and general and administrative expenses. We expect that available cash and cash flows generated from operations during 2008, along with current availability under our UBOC senior secured credit facility, will provide the capital necessary to fund these capital expenditures. See the Capital Expenditures section below for a more detailed discussion of our anticipated capital expenditures for 2008.

The Indenture governing our 9.75% Senior Notes due 2010, the seven-year \$200 million senior revolving credit facility and our senior secured credit facility with UBOC contain various covenants, including restrictions on additional indebtedness and payment of cash dividends. In addition, our senior secured credit facility contains covenants for maintenance of certain financial ratios. We were in compliance with these covenants at March 31, 2008. See Note 7 of the Consolidated Financial Statements for the year ended December 31, 2007 included in our Annual Report on Form 10-K filed March 17, 2008 for a more detailed discussion of long-term debt.

The following table describes our outstanding contractual obligations (in thousands) as of March 31, 2008:

| Contractual Obligations | Total | Less Than One Year | One-Three Years | Four-Five Years | After-Five Years |
|--------------------------------------|--------------|---------------------------|------------------------|------------------------|-------------------------|
| Senior Secured Credit Facility | \$ | \$ | \$ | \$ | \$ |
| 9.75% Senior Notes | 200,000 | | 200,000 | | |
| Senior Revolving Credit Facility (1) | 200,000 | | | | 200,000 |
| Throughput Commitments: | | | | | |
| Medusa Spar LLC | 5,028 | 2,184 | 2,844 | | |
| Medusa Oil Pipeline | 222 | 73 | 83 | 36 | 30 |
| | \$ 405,250 | \$ 2,257 | \$ 202,927 | \$ 36 | \$ 200,030 |

(1) Retired April 8, 2008

Capital Expenditures

Capital expenditures on an accrual basis were \$34 million for the three-months ended March 31, 2008. Included in the \$34 million were \$21 million of costs incurred for long lead items for the development of our Entrada Field. In addition, we incurred \$5 million for the drilling of a development well at our Medusa Field and \$3 million for drilling and completion activities in the Gulf of Mexico Shelf Area. Interest of approximately \$2 million and general and administrative costs allocable directly to exploration and development projects of approximately \$2 million were capitalized for the first three months of 2008. The remainder of the capital expended primarily includes the acquisition of seismic and leases.

Table of Contents

Capital expenditures for the remainder of 2008 are projected to be approximately \$146 million and include:
development wells and discretionary drilling of exploratory wells;

Entrada development costs;

the acquisition of seismic data and leases; and

capitalized interest and general and administrative costs.

In addition, we are projecting to spend \$11 million for the remainder of 2008 for asset retirement obligations.

Off-Balance Sheet Arrangements

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

Table of Contents**Results of Operations**

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

| | Three Months Ended March 31, | |
|---|---|-------------|
| | 2008 | 2007 |
| Net production : | | |
| Oil (MBbls) | 290 | 288 |
| Gas (MMcf) | 2,090 | 3,702 |
| Total production (MMcfe) | 3,828 | 5,427 |
| Average daily production (MMcfe) | 42.1 | 60.3 |
| Average sales price: | | |
| Oil (Bbls) (a) | \$ 86.66 | \$ 55.53 |
| Gas (Mcf) | 9.50 | 7.97 |
| Total (Mcf) | 11.75 | 8.38 |
| Oil and gas revenues: | | |
| Oil revenue | \$ 25,096 | \$ 15,968 |
| Gas revenue | 19,864 | 29,516 |
| Total | \$ 44,960 | \$ 45,484 |
| Oil and gas production costs: | | |
| Lease operating expenses | \$ 5,178 | \$ 6,599 |
| Additional per Mcfe data: | | |
| Sales price realized | \$ 11.75 | \$ 8.38 |
| Lease operating expense | 1.35 | 1.22 |
| Operating margin | \$ 10.40 | \$ 7.16 |
| Depletion, depreciation and amortization | \$ 3.93 | \$ 4.03 |
| General and administrative (net of management fees) | \$ 0.69 | \$ 0.41 |
| (a) Below is a reconciliation of the average NYMEX price to the average realized sales price per barrel of oil: | | |
| Average NYMEX oil price | \$ 97.90 | \$ 58.27 |
| Basis differential and quality adjustments | (3.65) | (5.11) |

| | | |
|----------------------------|----------|----------|
| Transportation | (1.25) | (1.14) |
| Hedging | (6.34) | 3.51 |
| Average realized oil price | \$ 86.66 | \$ 55.53 |

Table of Contents

Comparison of Results of Operations for the Three Months Ended March 31, 2008 and the Three Months Ended March 31, 2007.

Oil and Gas Production and Revenues

Total oil and gas revenues were \$45.0 million in the first quarter of 2008 compared to \$45.5 million in the first quarter of 2007. Total production on an equivalent basis for the first quarter of 2008 decreased by 29% compared to the first quarter of 2007. However, oil and gas prices on a Mcfe basis increased 40% compared to 2007.

Gas production during the first quarter of 2008 totaled 2.1 billion cubic feet (Bcf) and generated \$19.9 million in revenues compared to 3.7 Bcf and \$29.5 million in revenues during the same period in 2007. The average gas price after hedging impact for the first quarter of 2008 was \$9.50 per thousand cubic feet of natural gas (Mcf) compared to \$7.97 per Mcf for the same period last year. The 44% decrease in 2008 production was primarily attributable to the sale of our Mobile Bay 952,953,955 Field, early water production from our High Island Block 165, North Padre Island Block 913 and Prairie Beach fields and expected declines in production from our remaining properties.

Oil production during the first quarter of 2008 totaled 290,000 barrels and generated \$25.1 million in revenues compared to 288,000 barrels and \$16.0 million in revenues for the same period in 2007. The average oil price received after hedging impact in the first quarter of 2008 was \$86.66 per barrel compared to \$55.53 per barrel in the first quarter of 2007.

Lease Operating Expenses

Lease operating expenses were \$5.2 million for the three-month period ended March 31, 2008, a 22% decrease when compared to the same period in 2007. The decrease was primarily due to the sale of the Mobile Bay 952,953,955 Field effective May 1, 2007 and the shut-in of our North Padre Island Block 913 and Prairie Beach Fields, which are scheduled to be plugged and abandoned.

Depreciation, Depletion and Amortization

Depreciation, depletion and amortization for the three-month period ended March 31, 2008 and 2007 was \$15.1 million and \$21.8 million, respectively. The 31% decrease was due to lower production volumes and a lower depletion rate.

Accretion Expense

Accretion expense for the three-month period ended March 31, 2008 and 2007 of \$1.0 and \$1.1 million, respectively, represents accretion of our asset retirement obligations. See Note 6 to the Consolidated Financial Statements.

General and Administrative

General and administrative expenses, net of amounts capitalized, were \$2.7 million and \$2.2 million for the three-month period ended March 31, 2008 and 2007, respectively. The 19% increase was primarily the result of increased staffing costs.

Table of Contents

Interest Expense

Interest expense increased to \$9.9 million during the three month period ended March 31, 2008, compared to \$4.6 million during the three months ended March 31, 2007. This increase was due to the debt associated with the Entrada acquisition in April 2007. See Note 4 for more details.

Income Taxes

Income tax expense was \$4.1 million and \$3.8 million for the three-month period ended March 31, 2008 and 2007, respectively. The increase was primarily due to an increase in income before income taxes.

Table of Contents

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Commodity Price Risk

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

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

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

Callon may purchase puts which reduce the Company's exposure to decreases in oil and gas prices while allowing realization of the full benefit from any increases in oil and gas prices. If the price falls below the floor, the counter-party pays the difference to the Company.

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

See Note 3 to the Consolidated Financial Statements for a description of the Company's outstanding derivative contracts at March 31, 2008.

Table of Contents

Item 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Securities Exchange Act of 1934, as amended, is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. The Company's principal executive and principal financial officers have concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")) were effective as of March 31, 2008.

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

Table of Contents

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

Item 6. EXHIBITS

Exhibits

3. Articles of Incorporation and By-Laws
 - 3.1 Certificate of Incorporation of the Company, as amended (incorporated by reference from Exhibit 3.1 of the Company's Annual Report on Form 10-K for the year ended December 31, 2003 filed March 15, 2004, File No. 001-14039)
 - 3.2 Bylaws of the Company (incorporated by reference from Exhibit 3.2 of the Company's Registration Statement on Form S-4, filed August 4, 1994, Reg. No. 33-82408)
4. Instruments defining the rights of security holders, including indentures
 - 4.1 Specimen Common Stock Certificate (incorporated by reference from Exhibit 4.1 of the Company's Registration Statement on Form S-4, filed August 4, 1994, Reg. No. 33-82408)
 - 4.2 Rights Agreement between Callon Petroleum Company and American Stock Transfer & Trust Company, Rights Agent, dated March 30, 2000 (incorporated by reference from Exhibit 99.1 of the Company's Registration Statement on Form 8-A, filed April 6, 2000, File No. 001-14039)
 - 4.3 Form of Warrant entitling certain holders of the Company's 10.125% Senior Subordinated Notes due 2002 to purchase common stock from the Company (incorporated by reference to Exhibit 4.13 of the Company's Form 10-Q for the period ended June 30, 2002, File No. 001-14039)

Table of Contents

- 4.4 Form of Warrants dated December 8, 2003 and December 29, 2003 entitling lenders under the Company's \$185 million amended and restated Senior Unsecured Credit Agreement, dated December 23, 2003, to purchase common stock from the Company (incorporated by reference to Exhibit 4.14 of the Company's Annual Report on Form 10-K for the year ended December 31, 2003, File No. 001-14039)
- 4.5 Indenture for the Company's 9.75% Senior Notes due 2010, dated March 15, 2004, between Callon Petroleum Company and American Stock Transfer & Trust Company (incorporated by reference to Exhibit 4.16 of the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2004, File No. 001-14039)
- 10. Material Contracts
 - 10.1 Supplemental Indenture dated April 4, 2008 (incorporated by reference to Exhibit 10.1 of the Company's Report on Form 8-K filed on April 9, 2008)
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 - 10.5 Non-Recourse Guaranty dated April 4, 2008 (incorporated by reference to Exhibit 10.5 of the Company's Report on Form 8-K filed on April 9, 2008)
 - 10.6 Amendment to UBOC credit facility dated April 4, 2008 (incorporated by reference to Exhibit 10.6 of the Company's Report on Form 8-K filed on April 9, 2008)

Table of Contents

31. Certifications

31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32. Section 1350 Certifications

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Table of Contents

SIGNATURES

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

CALLON PETROLEUM COMPANY

Date: May 9, 2008

By: /s/ B.F. Weatherly
B.F. Weatherly, Executive Vice-President
and Chief Financial Officer

24

Table of Contents

Exhibit Index

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