CIMAREX ENERGY CO
Form 10-Q
August 09, 2005

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**(Mark One)**

| | |
|---|---|
| ý | **Quarterly Report Pursuant To Section 13 or 15(d) of the Securities Exchange Act of 1934** |
| **o** | **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934** |

**For the Quarterly Period ended June 30, 2005**
**Commission File No. 001-31446**

# CIMAREX ENERGY CO.

**1700 Lincoln Street, Suite 1800**

**Denver, Colorado 80203-4518**

**(303) 295-3995**

| | |
|---|---|
| **Incorporated in the State of Delaware** | **Employer Identification No. 45-0466694** |

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 ý No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ý No o

The number of shares Cimarex Energy Co. common stock outstanding as of June 30, 2005 was 82,076,316.

**CIMAREX ENERGY CO.**

**PART I**

Item 1 Financial Statements

Consolidated balance sheets (unaudited)
as of June 30, 2005 and December 31, 2004

Consolidated statements of operations (unaudited)
for the three and six months ended June 30, 2005 and 2004

Consolidated statements of cash flows (unaudited)
for the six months ended June 30, 2005 and 2004

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

Item 3 Qualitative and Quantitative Disclosures About Market Risk

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**PART II**

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***In this report, we use terms to discuss oil and gas producing activities as defined in Rule 4-10(a) of Regulation S-X. We express quantities of natural gas in terms of thousand cubic feet (Mcf), million cubic feet (MMcf) or billion cubic feet (Bcf). Oil is quantified in terms of barrels (Bbls), thousands of barrels (MBbls) and millions of barrels (MMBbls). Oil is compared to natural gas in terms of equivalent thousand cubic feet (Mcfe) or equivalent million cubic feet (MMcfe). One barrel of oil is the energy equivalent of six Mcf of natural gas. Information relating to our working interest in wells or acreage, net oil and gas wells or acreage is determined by multiplying gross wells or acreage by our working interest therein. Unless otherwise specified, all references to wells and acres are gross.***

**PART I**

**ITEM 1 - Financial Statements**

**CIMAREX ENERGY CO.**

Consolidated Balance Sheets

(Unaudited)

| | June 30, 2005 | December 31, 2004 |
|---|---|---|
| | (In thousands, except share data) | |
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 57,305 | $ 115,746 |
| Receivables, net | 208,042 | 103,989 |
| Inventories | 24,290 | 9,742 |
| Deferred income taxes | 23,183 | 2,149 |
| Assets available for sale | 8,434 | |
| Other current assets | 21,223 | 4,821 |
| Total current assets | 342,477 | 236,447 |
| Oil and gas properties at cost, using the full cost method of accounting: | | |
| Proved properties | 3,353,518 | 1,596,704 |
| Unproved properties and properties under development, not being amortized | 387,523 | 72,249 |
| | 3,741,041 | 1,668,953 |
| Less accumulated depreciation, depletion and amortization | (957,034) | (866,660) |
| Net oil and gas properties | 2,784,007 | 802,293 |
| Fixed assets, net | 87,947 | 16,109 |
| Goodwill | 730,399 | 44,967 |
| Other assets, net | 52,830 | 5,630 |
| | $ 3,997,660 | $ 1,105,446 |
| **Liabilities and Stockholders Equity** | | |
| Current liabilities: | | |
| Current maturities of long-term debt | $ 758 | $ |
| Accounts payable | 39,510 | 26,511 |
| Accrued liabilities | 171,962 | 77,362 |
| Derivative fair value | 30,742 | |
| Revenue payable | 73,280 | 39,129 |
| Total current liabilities | 316,252 | 143,002 |
| Long-term debt | 572,489 | |
| Deferred income taxes | 643,673 | 225,285 |
| Other liabilities | 161,640 | 36,447 |
| Stockholders equity: | | |
| Preferred stock, $0.01 par value, 15,000,000 shares authorized, no shares issued | | |
| Common stock, $0.01 par value, 200,000,000 shares authorized, 84,552,041 and 41,729,280 shares issued, respectively | 846 | 417 |
| Treasury stock, at cost, 2,475,725 shares held | (93,236) | |
| Paid-in capital | 1,858,256 | 250,248 |
| Unearned compensation | (18,187) | (10,072) |
| Retained earnings | 555,873 | 460,031 |

| | | | | |
|---|---|---|---|---|
| Accumulated other comprehensive income | | 54 | | 88 |
| | | 2,303,606 | | 700,712 |
| | $ | 3,997,660 | $ | 1,105,446 |

See accompanying notes to consolidated financial statements.

**CIMAREX ENERGY CO.**

Consolidated Statements of Operation

(Unaudited)

| | For the Three Months Ended June 30, 2005 | For the Three Months Ended June 30, 2004 | For the Six Months Ended June 30, 2005 | For the Six Months Ended June 30, 2004 |
|---|---|---|---|---|
| | (In thousands, except per share data) | | | |
| Revenues: | | | | |
| Gas sales | $ 137,159 | $ 90,864 | $ 243,033 | $ 165,196 |
| Oil sales | 47,862 | 24,450 | 79,370 | 45,628 |
| Gas gathering, marketing, and processing | 65,215 | 53,831 | 118,951 | 90,592 |
| Other, net | 2,222 | 1,048 | 2,811 | 4,696 |
| | 252,458 | 170,193 | 444,165 | 306,112 |
| Costs and expenses: | | | | |
| Depreciation, depletion and amortization | 51,582 | 30,834 | 89,667 | 57,172 |
| Asset retirement obligation accretion | 550 | 304 | 935 | 594 |
| Transportation | 3,608 | 2,493 | 6,082 | 4,848 |
| Production | 17,412 | 9,419 | 27,583 | 18,888 |
| Taxes other than income | 13,600 | 9,464 | 24,495 | 17,829 |
| Gas gathering, marketing, and processing | 63,987 | 53,286 | 117,214 | 89,586 |
| General and administrative | 7,657 | 5,133 | 15,549 | 9,642 |
| Stock compensation | 1,213 | 484 | 2,438 | 952 |
| Expenses related to merger | 6,685 | | 6,685 | |
| Loss on derivative instruments | 2,030 | | 2,030 | |
| | 168,324 | 111,417 | 292,678 | 199,511 |
| Operating income | 84,134 | 58,776 | 151,487 | 106,601 |
| Other income and expense: | | | | |
| Interest expense | 3,771 | 280 | 3,959 | 576 |
| Amortization of fair value of debt | (416) | | (416) | |
| Capitalized interest | (1,179) | | (1,179) | |
| Interest income and other | (693) | (102) | (1,345) | (189) |
| Income before income tax expense | 82,651 | 58,598 | 150,468 | 106,214 |
| Income tax expense | 30,174 | 22,128 | 54,626 | 39,879 |
| Net income | $ 52,477 | $ 36,470 | $ 95,842 | $ 66,335 |
| Earnings per share: | | | | |
| Basic | $ 1.01 | $ 0.88 | $ 2.04 | $ 1.60 |
| Diluted | $ 0.98 | $ 0.85 | $ 1.98 | $ 1.56 |
| Weighted average shares outstanding: | | | | |
| Basic | 51,967 | 41,379 | 46,886 | 41,342 |
| Diluted | 53,655 | 42,704 | 48,427 | 42,657 |

See accompanying notes to consolidated financial statements.

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**CIMAREX ENERGY CO**

Consoldiated Statements of Cash Flows

(Unaudited)

| | For the Six Months Ended June 30, 2005 | 2004 |
|---|---|---|
| | (In thousands) | |
| Cash flows from operating activities: | | |
| Net income | $ 95,842 | $ 66,335 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation, depletion and amortization | 89,667 | 57,172 |
| Asset retirement obligation accretion | 935 | 594 |
| Deferred income taxes | 36,119 | 27,299 |
| Stock compensation | 2,438 | 952 |
| Other | 8,357 | (6) |
| Changes in operating assets and liabilities, net of effects of the acquisition of Magnum Hunter: | | |
| (Increase) decrease in receivables, net | 17,341 | (22,060) |
| (Increase) decrease in other current assets | (11,962) | (4,435) |
| Increase (decrease) in accounts payable and accrued liabilities | (39,132) | 16,812 |
| Increase (decrease) in other non-current liabilities | (399) | 158 |
| Net cash provided by operating activities | 199,206 | 142,821 |
| Cash flows from investing activities: | | |
| Oil and gas expenditures | (204,428) | (128,299) |
| Acquisition of proved oil and gas properties | (1,948) | (2) |
| Merger related costs | (11,134) | |
| Cash received in connection with acquisition of MHR | 33,407 | |
| Proceeds from sale of assets | 405 | 452 |
| Other expenditures | (17,362) | (3,386) |
| Net cash used by investing activities | (201,060) | (131,235) |
| Cash flows from financing activities: | | |
| Borrowing (payments) on long-term debt, net | (60,064) | |
| Financing costs | (1,370) | |
| Common stock reacquired and retired | (2,130) | (121) |
| Proceeds from issuance of common stock | 6,977 | 6,196 |
| Net cash (used in) provided by financing activities | (56,587) | 6,075 |
| Net change in cash and cash equivalents | (58,441) | 17,661 |
| Cash and cash equivalents at beginning of period | 115,746 | 40,420 |
| Cash and cash equivalents at end of period | $ 57,305 | $ 58,081 |

See accompanying notes to consolidated financial statements.

**CIMAREX ENERGY CO.**

Notes to Consolidated Financial Statements

June 30, 2005

(Unaudited)

**1.** Basis of Presentation

The accompanying financial statements are unaudited and were prepared from the records of Cimarex Energy Co. (Cimarex or the Company). We believe these financial statements include all adjustments necessary for a fair presentation of our financial position and results of operations. We prepared these statements on a basis consistent with the annual audited statements and Regulation S-X. Regulation S-X allows us to omit some of the footnote and policy disclosures required by accounting principles generally accepted in the United States of America and normally included in annual reports on Form 10-K. These interim financial statements should be read in conjunction with the financial statements and notes in our Annual Report on Form 10-K for the year ended December 31, 2004.

Cimarex was formed in February 2002 as a wholly-owned subsidiary of Helmerich & Payne, Inc. (H&P). As a result of a dividend declared and paid by H&P on September 30, 2002, in the form of Cimarex common stock, Cimarex was spun-off and became a stand-alone company. Also on September 30, 2002, Cimarex acquired 100 percent of the outstanding common stock of Key Production Company, Inc. (Key) in a tax-free exchange.

In June 2005, Cimarex acquired Magnum Hunter Resources, Inc. Terms of the merger agreement provided that Magnum Hunter stockholders receive 0.415 shares of Cimarex common stock for each share of Magnum Hunter common stock. As a result of the merger, Cimarex issued 39.7 million common shares to Magnum Hunter s common stockholders (excluding 2.5 million shares held in treasury). At June 30, 2005, the combined company had 82.1 million shares outstanding, and Cimarex stockholders owned 51.6 percent and Magnum Hunter stockholders 48.4 percent. The merger was accounted for as a purchase of Magnum Hunter by Cimarex.

The accounts of Cimarex and its subsidiaries are presented in the accompanying consolidated financial statements. All intercompany accounts and transactions were eliminated in consolidation.

We make certain estimates and assumptions to prepare our financial statements in conformity with accounting principles generally accepted in the United States of America. Those estimates and assumptions affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses during the reporting period and in disclosures of commitments and contingencies. Changes in facts and circumstances may result in revised estimates and actual results could differ from those estimates.

The more significant areas requiring the use of management s estimates and judgments relate to the estimation of proved oil and gas reserves, the use of these oil and gas reserves in calculating depletion, depreciation and amortization, the use of the estimates of future net revenues in computing ceiling test limitations and estimates of future abandonment obligations used in recording asset retirement obligations. Estimates and judgments are also required in determining reserves for bad debt, impairments of undeveloped properties, the purchase price allocation, assessment of goodwill and valuation of deferred tax assets.

Certain amounts in the accompanying consolidated financial statements for prior periods have been reclassified to conform to the current year presentation.

**2.** Business Combination

On June 7, 2005, Cimarex completed the acquisition of Magnum Hunter Resources, Inc, an independent oil and gas exploration and production company with operations concentrated in the Permian Basin of West Texas and New Mexico and in the Gulf of Mexico. Terms of the merger agreement provided that Magnum Hunter stockholders receive 0.415 shares of Cimarex common stock for each share of Magnum Hunter common stock. As a result of the merger, Cimarex issued 39.7 million common shares to Magnum Hunter s common stockholders (excluding 2.5 million shares held in treasury).

We believe that the merger provides the opportunity to expand our existing core areas and to add new projects, without jeopardizing our strong financial position; a substantial footprint in the Permian Basin from which we can grow; complementary operations in the Mid-Continent and Gulf Coast areas; measured exposure to high potential projects in the Gulf of Mexico; and the ability to greatly expand our balanced-risk drilling program underpinned by a strong balance sheet.

The consolidated balance sheet at June 30, 2005, includes the estimated fair value of assets and liabilities of Magnum Hunter on June 7, 2005, as well as the adjustments required to record the acquisition in accordance with the purchase method of accounting. The results of operations of Magnum Hunter are included in our consolidated statements of operations for the period since the acquisition on June 7, 2005.

The purchase price of Magnum Hunter s assets was based on the value of Cimarex common stock issued to the Magnum Hunter stockholders and the fair value of assumed liabilities. The value of the common stock issued is based on the weighted average price of Cimarex s common stock for the period beginning two days before and ending two days after the announcement of the merger, or $37.66 per share. The purchase price also includes merger costs incurred, which include employee severance costs, investment banking expenses, legal and accounting fees, printing expenses and other related costs.

| | | |
|---|---|---|
| Purchase Price (in millions): | | |
| Shares of Cimarex common stock issued to Magnum Hunter stockholders | | 39.7 |
| Average Cimarex stock price | $ | 37.66 |
| | | |
| Fair value of common stock issued | $ | 1,495.4 |
| Plus: Merger costs incurred | | 30.5 |
| Total purchase price | | 1,525.9 |
| Plus: Liabilities assumed by Cimarex: | | |
| Current liabilities | | 156.2 |
| Fair value of long-term debt | | 633.0 |
| Other non-current liabilities (Includes fair value of common stock associated with convertible debt | | 122.5 |
| Deferred income taxes | | 425.8 |
| Total purchase price plus liabilities assumed | $ | 2,863.4 |
| Allocation of Purchase Price: | | |
| Current assets | $ | 177.3 |
| Proved oil and gas properties | | 1,537.0 |
| Unproved oil and gas properties | | 297.7 |
| Investments | | 45.6 |
| Other property and equipment | | 52.8 |
| Other non-current assets | | 67.6 |
| Goodwill | | 685.4 |
| | $ | 2,863.4 |

The allocation of the purchase price to oil and gas properties utilized prevailing oil and gas prices at the time of negotiations and announcement of the merger. The overall allocation of the purchase price is preliminary because certain items such as the determination of the final fair value of certain assets and liabilities as of the acquisition date have not been finalized.

Included in current assets are assets available for sale of approximately $8.4 million which are attributable to certain assets acquired in the Magnum Hunter merger of which $7.4 million were sold in July 2005.

The following unaudited pro forma information has been prepared to give effect to the Magnum Hunter acquisition as if it had occurred at the beginning of the periods presented. The unaudited pro forma data is presented for illustrative purposes only, based on estimates and assumptions deemed appropriate by management, and should not be relied upon as an indication of the operating results that Cimarex would have achieved if the transaction had occurred on January 1, 2004. The pro forma information also should not be used as an indication of future results or trends.

| | | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|---|
| **(Thousands of dollars, except per share data)** | | **2005** | **2004** | **2005** | **2004** |
| **Pro Forma Statement of Operations Data** | | | | | |
| Revenues | $ | 379,516 | 280,830 | 719,258 | 517,447 |
| Net income | | 122,792(1) | 49,926 | 171,441 | 84,241 |
| Net income per share: | | | | | |
| Basic | $ | 1.50 | 0.62 | 2.10 | 1.04 |
| Diluted | | 1.48 | 0.61 | 2.07 | 1.02 |

(1) Includes $19.2 million unrealized mark-to-market gains on derivatives.

**3.** Derivatives

SFAS No.133, *Accounting for Derivative Instruments and Hedging activities,* requires that all derivatives be recorded on the balance sheet at fair value. We generally determine the fair value of commodity futures and swap contracts based on the difference between the fixed contract price and the underlying market price at the determination date. Realized and unrealized gains and losses on derivatives that are not designated as hedges are recorded as an expense. In connection with the Magnum Hunter merger, Cimarex recognized a $39.3 million liability associated with Magnum Hunter s existing commodity derivatives at the merger date (June 7, 2005). These derivative instruments have not been designated for hedge accounting treatment. As a result, Cimarex recognized a net loss during the second quarter of $2.0 million. The derivative liability at June 30, 2005 equals $41.4 million. Cimarex will continue to recognize gains and losses in future earnings as the remaining derivative instruments expire through December 31, 2006.

At June 30, 2005, the fair values of the derivative instruments were as follows (in thousands):

| **Derivative Liabilities** | | |
|---|---|---|
| Natural Gas Collars | $ | 23,906 |
| Natural Gas Swaps | | 4,010 |
| Crude Oil Collars | | 9,176 |
| Crude Oil Swaps | | 4,280 |
| Derivative Liability | $ | 41,372 |

Of the $41.4 million of total derivative liabilities, $30.8 million is classified as current and $10.6 million is included in other long-term liabilities on our consolidated balance sheet at June 30, 2005.

**4.** Stock Options

Cimarex s 2002 Stock Incentive Plan reserves 12.7 million shares of common stock for issuance to directors and employees, including officers. Options granted under the plan after December 5, 2002, expire ten years from the grant date and vest in one-fifth increments on each of the first five anniversaries of the grant date. All grants are made at the closing price of our common stock as reported on the New York Stock Exchange on the date of grant.

Upon the exercise of the options for shares of common stock, the employee is required to hold at least 50 percent of the profit shares, as defined in the plan, until the eighth anniversary of the grant date. The incentive plan provides for accelerated vesting if there is a change in control (as defined in the plan).

For periods prior to January 1, 2005, we applied Accounting Principles Board (APB) Opinion 25, *Accounting for Stock Issued to Employees*, and related interpretations to account for all stock option grants. No compensation cost had been recognized for stock options granted, as the option prices were equal to the market price of the underlying common stock on the date of grant.

Effective January 1, 2005, we adopted the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123R, *Share Based Payment* on a prospective basis. SFAS No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation to employees. For the quarter and six months ended June 30, 2005 amortization of compensation expense related to stock options was approximately $.7 million and $1.4 million or $.4 million and $.8 million after tax ($0.01 and $0.03 per diluted share respectively).

As discussed more fully in the notes to the financial statements of our annual report on form 10-K for the year ended December 31, 2004, the merger with Magnum Hunter constituted a change of control event under the incentive plan. As a result, all participants became entitled to acceleration of vesting of their options. Cimarex obtained waivers of the accelerated vesting from certain option holders including the company s CEO and other senior officers. Option holders who were not requested to or did not choose to execute a waiver became fully vested in their options on June 7, 2005.

Compensation expense related to the accelerated vesting of options was approximately $1.1 million, or $.7 million after tax ($.01 per diluted share) for the quarter and six months ended June 30, 2005.

The fair value of each option award was estimated as of the date of grant using the Black-Scholes option-pricing model. Expected volatilities were based on the historical volatility of our common stock. The risk free interest rate is based on U.S. Treasury Securities at a constant five year fixed maturity in effect at the date of the grant. Historical data was also used to estimate the probability of option exercise, expected years until exercise and employee termination within the valuation model.

Had compensation cost for the plan been determined based on the fair value at the grant dates for awards to employees under the plan, consistent with the methodology of SFAS No. 123R for the quarter and six months ended June 30, 2004, such compensation expense would have been approximately $.9 million and $1.7 million, respectively. Pro forma net income for the quarter and six months ended June 30, 2004 would have been as indicated below:

| | | Three Months Ended June 30, 2004 | | Six Months Ended June 30, 2004 |
| --- | --- | --- | --- | --- |
| | | (In thousands except per share amounts) | | |
| Net income, as reported | $ | 36,470 | $ | 66,335 |
| Less: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | | (538) | | (1,075) |
| Pro forma net income | $ | 35,932 | $ | 65,260 |
| Earnings per share: | | | | |
| Basic as reported | $ | .88 | $ | 1.60 |
| Basic pro forma | $ | .87 | $ | 1.58 |
| Diluted as reported | $ | .85 | $ | 1.56 |
| Diluted pro forma | $ | .84 | $ | 1.53 |

There were no stock options granted to employees during the three months and six months ended June 30, 2005 and 2004.

The following summary reflects the status of stock options granted to employees and directors as of June 30, 2005, and changes during the period:

| | Shares | | Weighted Average Exercise Price | Weighted Average Remaining Term | | Aggregate Intrinsic Value ($000) |
| --- | --- | --- | --- | --- | --- | --- |
| Outstanding as of January 1, 2005 | 2,657,082 | $ | 14.95 | | | |
| Exercised | (298,364) | | 13.61 | | | |
| Granted | | | | | | |
| Canceled | (5,315) | | 14.01 | | | |
| Outstanding as of June 30, 2005 | 2,353,403 | $ | 15.12 | 6.0 Years | $ | 56,521 |
| Exercisable as of June 30, 2005 | 1,683,821 | $ | 14.47 | 6.2 Years | $ | 41,535 |

The total intrinsic value of options exercised during the three months ended June 30, 2005 and 2004 was $3.4 million and $.2 million, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2005 and 2004 was $4.1 million and $4.5 million, respectively.

The following summary reflects the status of nonvested stock options granted to employees and directors as of June 30, 2005, and changes during the period:

| | Shares | | Weighted Average Grant Date Fair Value |
|---|---|---|---|
| Nonvested as of January 1, 2005 | 883,327 | $ | 17.02 |
| Vested | (208,430) | | 17.96 |
| Granted | | | |
| Forfeited | (5,315) | | 14.01 |
| Nonvested as of June 30, 2005 | 669,582 | $ | 16.75 |
| Exercisable as of June 30, 2005 | 1,683,821 | $ | 14.47 |

As of June 30, 2005 there was $4.5 million of total unrecognized compensation cost related to non- vested share-based compensation arrangements granted under our incentive plan. That cost is expected to be recognized pro rata over a weighted-average period of 7.7 years. Generally, options vest on the anniversary of the grant date. However, as noted above, the merger with Magnum Hunter resulted in certain option holders becoming fully vested in their options as of June 7, 2005. The fair value attributable to such vested shares was approximately $1.1 million.

Cash received from option exercises during the six months ended June 30, 2005 and 2004 was approximately $4.1 million and $4.5 million, respectively. The tax benefit realized for the tax deductions from option exercises totaled approximately $2.9 million and $1.7 million, for the six months ended June 30, 2005 and 2004, respectively.

## 5. Asset Retirement Obligations

On January 1, 2003, we adopted SFAS No. 143, *Accounting for Asset Retirement Obligations*. This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The Statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made, and that the associated asset retirement costs be capitalized as part of the carrying amount of the long-lived asset. Oil and gas producing companies incur this liability upon acquiring or drilling a well.

The following table reflects the components of the change in the carrying amount of the asset retirement obligation for the six months ended June 30, 2005 (in thousands):

| | | |
|---|---|---|
| Balance as of January 1, 2005 | $ | 19,762 |
| Liabilities incurred in the current period | | 2,254 |
| Liabilities assumed in the Magnum Hunter merger | | 68,908 |
| Liabilities settled in the current period | | (196) |
| Accretion expense | | 976 |
| Balance as of June 30, 2005 | | 91,704 |
| Less: Current asset retirement obligation | | (3,552) |
| Long-term asset retirement obligation | $ | 88,152 |

**6.** Long-Term Debt

Prior to the Magnum Hunter merger, Cimarex had no debt. In connection with the Magnum Hunter merger on June 7, 2005, Cimarex assumed the following debt (in thousands):

| | | |
|---|---|---|
| Bank debt under revolving credit facility | $ | 270,000 |
| Capital lease obligations | | 3,501 |
| 9.6% Senior unsecured notes, due March 15, 2012 (face value $195,000) | | 215,475 |
| Floating rate convertible senior notes, due December 15, 2023 (face value $125,000) | | 144,750(1) |
| | | 633,726 |
| Less: Current portion of capital lease obligations | | (758) |
| Total long-term debt | $ | 632,968 |

Debt at June 30, 2005 consisted of the following (in thousands):

| | | |
|---|---|---|
| Bank debt under revolving credit agreements, due July 1, 2010, 4.945% at June 30, 2005 | $ | 210,000 |
| Capital lease obligations | | 3,438 |
| 9.6% Senior unsecured notes, due March 15, 2012 | | 215,280 |
| Floating rate convertible senior notes, due December 15, 2023, 3.41% at June 30, 2005 | | 144,529(1) |
| | $ | 573,247 |
| Less: Current portion of capital lease obligations | | (758) |
| Total long-term debt | $ | 572,489 |

(1) Reflected in Other Liabilities is $44 million related to the fair value of common stock associated with the convertible debt.

We have the capability to borrow on a Senior Secured Revolving Credit Facility. Prior to June 13, 2005 the Facility had a borrowing base of $300 million and commitments from our lenders totaling $200 million. On June 13, 2005 the Facility was amended and restated, establishing an $825 million borrowing base and a commitment amount of $500 million. On a semi-annual basis, our borrowing base under the Facility is redetermined by the financial institutions who have committed to the Company, based on their review of our proved oil and gas reserves and other assets.

The amended and restated Credit Facility is secured by mortgages on certain of our oil and gas properties and the stock of our operating subsidiaries. We are also subject to customary financial and non-financial covenants and are in compliance with those covenants. Borrowings under the amended facility bear interest at a LIBOR rate plus 1.00 percent to 1.75 percent, based on borrowing base usage. Unused borrowings under the amendment are subject to a commitment fee of 0.225 percent to 0.375 percent, also depending on borrowing base usage. We also have a letter of credit posted against our borrowing base of $2.5 million. While we have no actual borrowings against this letter of credit, it reduces our funds available under the borrowing base. The letter of credit was posted to cover any plugging and abandonment costs, as well as potential environmental remediation costs after the property is plugged.

All long-term debt is guaranteed by Cimarex and all of its subsidiaries, except Canvasback. Total assets held by Canvasback equal $2.1 million.

On February 18, 2005, Magnum Hunter s 40% owned subsidiary, Apple Tree Holdings, LLC ( Apple Tree ), entered into a $20.6 million construction loan agreement ( Construction Loan ). The Construction Loan provides financing for the construction of a processing plant, natural gas lateral, carbon dioxide line and related infrastructure in Huerfano County, Colorado. The Construction Loan bears interest at LIBOR plus 2.25% or a base rate plus 1.25%, and will mature no later than July 31, 2006. Total borrowings under this loan at June 30, 2005 were $10.5 million, of which our share was $4.2 million. Magnum Hunter also provided a guarantee to the lender for 100% of the loan. In return for the guarantee, Magnum Hunter received an up-front fee and the right to receive 55% of distributable cash flows from Apple Tree until certain financial tests are met. In the merger, Cimarex assumed Magnum Hunter s obligation. In the event that the Construction Loan goes into default and we have to perform under the guarantee, we will have recourse against the project and related subsidiaries. We have included $162 thousand in other liabilities on our condensed consolidated balance sheet to represent the fair value of our guarantee for the Construction Loan.

## 7. Income Taxes

Federal income tax expense for the periods ended June 30, 2005 and 2004 differ from the amounts that would be provided by applying the U.S. Federal income tax rate due to the effect of state income taxes and other deductible costs.

The components of our provision for income taxes are as follows (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Current taxes | $ 11,367 | $ 5,753 | $ 18,507 | $ 12,580 |
| Deferred taxes | 18,807 | 16,375 | 36,119 | 27,299 |
| | $ 30,174 | $ 22,128 | $ 54,626 | $ 39,879 |

**8.** Supplemental Disclosure of Cash Flow Information (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Cash paid during the period for: | | | | |
| Interest (net of amounts capitalized) | $ 1,512 | $ 42 | $ 1,692 | $ 475 |
| Income taxes (net of refunds received) | $ 11,112 | $ 11,346 | $ 13,102 | $ 13,052 |

**9.** Earnings Per Share

The calculations of basic and diluted net earnings per common share are presented below:

| | Three Months Ended June 30, 2005 | Three Months Ended June 30, 2004 | Six Months Ended June 30, 2005 | Six Months Ended June 30, 2004 |
|---|---|---|---|---|
| | (in thousands, except per share data) | | | |
| Net income available to common stockholders for basic and diluted shares | $ 52,477 | $ 36,470 | $ 95,842 | $ 66,335 |
| Basic weighted-average shares outstanding | 51,967 | 41,379 | 46,886 | 41,342 |
| Incremental shares from assumed exercise of stock options, vesting of restricted stock units and conversion of convertible senior notes | 1,688 | 1,325 | 1,541 | 1,315 |
| Diluted weighted-average shares outstanding | 53,655 | 42,704 | 48,427 | 42,657 |
| Earnings per share: | | | | |
| Basic | $ 1.01 | $ 0.88 | $ 2.04 | $ 1.60 |
| Diluted | $ 0.98 | $ 0.85 | $ 1.98 | $ 1.56 |

There were stock options outstanding for 2,353,403 and 2,996,304 shares of Cimarex common stock at June 30, 2005 and 2004, respectively. All stock options were considered potentially dilutive securities for each of the periods presented.

**10.** Segment Information

We have two reportable segments. The Exploration and Production segment is engaged in exploratory and developmental drilling and acquisition, production, and sale of crude oil, condensate, and natural gas. The Gas Gathering, Marketing, and Processing segment is engaged in the gathering and compression of natural gas from the wellhead, the purchase and resale of natural gas that it gathers, and the processing of natural gas liquids. The accounting policies of the segments are the same as those for the company as a whole.

Summarized financial information of Cimarex s reportable segments for the three and six months ended June 30, 2005 and 2004 is shown in the following tables:

| | External Sales | Segment Operating Profit Before Income Taxes | DD&A (In thousands) | Total Assets(1) | Additions to Long-Lived Assets |
|---|---|---|---|---|---|
| **Three Months Ended June 30, 2005:** | | | | | |
| Exploration and Production | $ 185,021 | $ 91,144 | $ 51,032 | $ 3,880,800 | $ 2,040,830 |
| Gas Gath., Mkting., and Proc. | 65,215 | 662 | 550 | 116,860 | 53,877 |
| **Total** | $ 250,236 | $ 91,806 | $ 51,582 | $ 3,997,660 | $ 2,094,707 |
| **Three Months Ended June 30, 2004:** | | | | | |
| Exploration and Production | $ 115,314 | $ 57,280 | $ 30,771 | $ 899,418 | $ 82,974 |
| Gas Gath., Mkting, and Proc. | 53,831 | 448 | 63 | 47,645 | 82 |
| **Total** | $ 169,145 | $ 57,728 | $ 30,834 | $ 947,063 | $ 83,056 |

| | External Sales | Segment Operating Profit Before Income Taxes | DD&A (In thousands) | Total Assets(1) | Additions to Long-Lived Assets |
|---|---|---|---|---|---|
| **Six Months Ended June 30, 2005:** | | | | | |
| Exploration and Production | $ 322,403 | $ 157,478 | $ 89,044 | $ 3,880,800 | $ 2,136,375 |
| Gas Gath., Mkting., and Proc. | 118,951 | 1,092 | 623 | 116,860 | 54,405 |
| **Total** | $ 441,354 | $ 158,570 | $ 89,667 | $ 3,997,660 | $ 2,190,780 |
| **Six Months Ended June 30, 2004:** | | | | | |
| Exploration and Production | $ 210,824 | $ 101,058 | $ 57,049 | $ 899,418 | $ 153,241 |
| Gas Gath., Mkting, and Proc. | 90,592 | 847 | 123 | 47,645 | 394 |
| **Total** | $ 301,416 | $ 101,905 | $ 57,172 | $ 947,063 | $ 153,635 |

(1) 2005 includes a preliminary allocation of $730 million of Goodwill to the Exploration and Production segment.

The acquisition of Magnum Hunter materially increased total assets within the two noted segments. Additions attributable to the segments related to the Magnum Hunter merger were $1.9 billion to Exploration and Production (includes Equity investment of $45.5 million) and $52.8 million to Gas Gathering, Marketing and processing.

The following table reconciles segment operating profit per the above table to income before taxes as reported on the consolidated statements of operations (in thousands).

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2005** | **2004** | **2005** | **2004** |
| Segment operating profit including depreciation, depletion and amortization | $ 91,806 | $ 57,728 | $ 158,570 | $ 101,905 |
| Unallocated amounts: | | | | |
| Other revenue, net | 2,222 | 1,048 | 2,811 | 4,696 |
| Expenses related to merger | (6,685) | — | (6,685) | — |
| Loss on derivative instruments | (2,030) | — | (2,030) | — |
| Income from equity investees | 30 | — | 30 | — |
| Loss from assets held for sale | (55) | — | (55) | — |
| Interest income | 718 | 102 | 1,370 | 189 |
| Interest expense | (3,355) | (280) | (3,543) | (576) |
| | $ 82,651 | $ 58,598 | $ 150,468 | $ 106,214 |

**11.** Commitments and Contingencies

***Litigation***

Cimarex has various litigation related matters in the normal course of business, none of which are material, individually or in aggregate.

***Gas Deliveries***

We have firm sales contracts to deliver fixed volumes of gas based on an index price. These contracts vary in length from two months to one year. As of June 30, 2005, we had an obligation to deliver approximately 3.7 Bcf of natural gas. If this gas is not delivered, our financial commitment would be approximately $20.2 million base on index prices as of July 1, 2005. This commitment will fluctuate due to price volatility and actual volumes delivered. We believe no financial commitment will be due based on our reserves and current production levels.

Cimarex has other various delivery commitments in the normal course of business, none of which are individually material. In aggregate these commitments have a maximum amount that would be payable, if no gas is delivered, of approximately $5 million.

***Drilling Commitments***

The Company has contractual commitments on oil and gas wells approved for drilling or in the process of being drilled at June 30, 2005 of approximately $85.2 million. All of the noted commitments were routine and made in the normal course of our business.

***Tax Sharing Agreement***

On September 30, 2002, Cimarex entered into an agreement with H&P that provides indemnification of H&P in connection with any future tax claims that may be made relating to the oil and gas exploration and production assets contributed to Cimarex by H&P.

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

***Throughout this Form 10-Q, we make statements that may be deemed forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities and Exchange Act of 1934. These forward-looking statements include, among others, statements concerning Cimarex s outlook with regard to timing and amount of future production of oil and gas, price realizations, amounts, nature and timing of capital expenditures for exploration and development, plans for funding operations and capital expenditures, drilling of wells, operating costs and other expenses, marketing of oil and gas and other statements of expectations, beliefs, future plans and strategies, anticipated events or trends, and similar expressions concerning matters that are not historical facts. The forward-looking statements in this report are subject to risks and uncertainties that could cause actual results to differ materially from those expressed in or implied by the statements.***

***These risks and uncertainties include, but are not limited to, fluctuations in the price we receive for our oil and gas production, reductions in the quantity of oil and gas sold due to decreased industry-wide demand and/or curtailments in production from specific properties due to mechanical, marketing or other problems, operating and capital expenditures that are either significantly higher or lower than anticipated because the actual cost of identified projects varied from original estimates and/or from the number of exploration and development opportunities being greater or fewer than currently anticipated, and increased financing costs due to a significant increase in interest rates. In addition, exploration and development opportunities pursued by Cimarex may not result in productive oil and gas properties. There are also numerous uncertainties inherent in estimating quantities of proved reserves, projecting future rates of production and the timing of development expenditures. These and other risks and uncertainties affecting Cimarex are discussed in greater detail in this report and in other filings by Cimarex with the Securities and Exchange Commission.***

**INTRODUCTION**

Cimarex Energy Co. is an independent oil and gas exploration and production company. Our operations are presently focused in Oklahoma, Texas, New Mexico, Kansas and Louisiana. Our primary focus is to explore for and discover new reserves. To supplement our growth, we also consider acquisitions and mergers, such as the acquisition of Magnum Hunter Resources, Inc. On June 7, 2005, Cimarex completed its acquisition of Magnum Hunter Resources, Inc, an independent oil and gas exploration and production company with operations concentrated in the Permian Basin of West Texas and New Mexico and in the Gulf of Mexico. Terms of the merger agreement provided that Magnum Hunter stockholders receive 0.415 shares of Cimarex common stock for each owned share of Magnum Hunter common stock. As a result of the merger transaction, Cimarex issued 39.7 million common shares to Magnum Hunter s common stockholders (excluding 2.5 million shares held in treasury). At June 30, 2005, the combined company had 82.1 million shares outstanding, and Cimarex stockholders owned 51.6 percent and Magnum Hunter stockholders 48.4 percent. The merger was accounted for as a purchase of Magnum Hunter by Cimarex. The results of operations of Magnum Hunter are included in our consolidated statements of operations for the period since the acquisition on June 7, 2005.

We believe that the merger provides: the opportunity to expand our existing core areas and to add new projects, without jeopardizing our strong financial position; a substantial footprint in the Permian Basin from which we can grow; complementary operations in the Mid-Continent and Gulf Coast areas; measured exposure to high potential projects in the Gulf of Mexico; and the ability to greatly expand our balanced-risk drilling program underpinned by a strong balance sheet.

*Industry and Economic Factors*

In managing our business, we must deal with many factors inherent in our industry. First and foremost is wide fluctuation of oil and gas prices. Historically, oil and gas markets have been cyclical and volatile, with future price movements difficult to predict. While our revenues are a function of both production and prices, it is wide swings in prices that have most often had the greatest impact on our results of operations.

Our operations entail significant complexities. Advanced technologies requiring highly trained personnel are utilized in both exploration and production. Even when the technology is properly used, the interpreter still may not know conclusively if hydrocarbons will be present or the rate at which they will be produced. Exploration is a high-risk activity, often times resulting in no commercially productive reservoirs being discovered. Moreover, costs associated with operating within the industry are substantial.

The oil and gas industry is highly competitive. We compete with major and diversified energy companies, independent oil and gas businesses, and individual operators. In addition, the industry as a whole competes with other businesses that supply energy to industrial and commercial end users.

Extensive Federal, state and local regulation of the industry significantly affects our operations. In particular, our activities are subject to stringent environmental regulations. These regulations have increased the costs of planning, designing, drilling, installing, operating, and abandoning oil and gas wells and related facilities. These regulations may become more demanding in the future.

*Approach to the Business*

Profitable growth of our assets will largely depend upon our ability to successfully find and develop new proved reserves. To accommodate an overall acceptable rate of growth, we maintain a blended portfolio of low, moderate and higher risk exploration and development projects. We believe that this approach allows for consistent increases in our oil and gas reserves, while minimizing the chance of failure. To further mitigate risk, we have chosen to seek geologic and geographic diversification by operating in multiple basins. We may also consider the use of transaction-specific hedging of oil and gas prices to reduce price risk. To date the use of hedging has not been implemented by Cimarex. However, in connection with the acquisition of Magnum Hunter, we acquired existing commodity derivatives as discussed more fully below.

Implementation of our business approach relies on our ability to fund ongoing exploration and development projects with cash flow provided by operating activities and external sources of capital.

For the full-year 2005, we project that 2005 exploration and development expenditures will approximate $560 million, of which $325 million will be spent in the second half of 2005. This $560 million is up from $296 million in 2004. Our 2005 exploration and development expenditures pro forma on a full year basis for Magnum Hunter are expected to approximate $700 million. Included in anticipated 2005 expenditures is approximately $300 million related to Magnum Hunter projects, focused primarily in the Gulf of Mexico (approximately $200 million) and the Permian Basin (approximately $100 million). In addition to the new drilling opportunities resulting from the merger, we are also expanding our traditional Mid-Continent and onshore Gulf Coast programs. A total of $200 million is anticipated to be invested in western Oklahoma and the Texas Panhandle. We also plan to invest $145 million in the upper Gulf Coast Regions of Texas and Louisiana.

Exploration and development expenditures during the second quarter of 2005 totaled $141.0 million, up from $81.6 million for the second quarter of 2004. Capital expenditures for exploration and development during the first six months of 2005 were $233.7 million, up from $150.2 million during the first two quarters of 2004. In the second quarter of 2005, we participated in drilling 121 gross (60 net) wells, with an overall success rate of 93 percent. We drilled 180 gross (96 net) wells during the first six months of 2005, realizing a success rate of 89 percent.

Cash flow from operating activities for the six months ended June 30, 2005 totaled $199.2 million, helping to fund our exploration and development expenditure program. Due to positive drilling results during 2004 and the first half of 2005, approximately six percent of our year-to-date oil and gas production contributing to this cash flow was generated from new wells going on line within the first half of 2005.

Based on expected cash provided by operating activities, and available under our Senior Secured Revolving Credit Facility, we believe we are well positioned to fund the projects identified for the remainder of 2005 and beyond.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Our discussion and analysis of our financial condition and results of operation are based upon consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Our significant accounting policies are described in Note 3 to our consolidated financial statements included in our Form 10-K for the year ended December 31, 2004. In response to SEC Release No. 33-8040, Cautionary Advice Regarding Disclosure about Critical Accounting Policies, we have identified certain of these policies as being of particular importance to the portrayal of our financial position and results of operations and which require the application of significant judgment by our management. We analyze our estimates, including those related to oil and gas revenues, reserves and properties, as well as goodwill and contingencies, and base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

*Revenue Recognition*

Revenues from oil and gas sales are recognized based on the sales method, with revenue recognized on actual volumes sold to purchasers. There is a ready market for oil and gas, with sales occurring soon after production.

*Oil and Gas Reserves*

The process of estimating quantities of oil and gas reserves is complex, requiring significant decisions in the evaluation of all available geological, geophysical, engineering and economic data. The data for a given field may also change substantially over time as a result of numerous factors including, but not limited to, additional development activity, evolving production history and continual reassessment of the viability of production under varying economic conditions. As a result, material revisions to existing reserve estimates may occur from time to time. Although every reasonable effort is made to ensure that reserve estimates reported represent the most accurate assessments possible, the subjective decisions and variances in available data for various fields make these estimates generally less precise than other estimates included in the financial statement disclosures. For 2004, revisions of reserve estimates (excluding Magnum Hunter reserves) resulted in an increase of 1.2 MMBbls of oil and an increase of 20.1 Bcf of gas, representing eight percent and five percent of proved oil and gas reserves, respectively, as of

December 31, 2004.

We use the units-of-production method to amortize our oil and gas properties. Changes in reserve quantities will cause corresponding changes in depletion expense in periods subsequent to the quantity revision or, in some cases, a full cost ceiling limitation charge in the period of the revision. To date, changes in expense resulting from changes in previous estimates of reserves have not been material.

*Derivatives*

SFAS No.133, *Accounting for Derivative Instruments and Hedging activities,* requires that all derivatives be recorded on the balance sheet at fair value. We generally determine the fair value of futures contracts and swap contracts based on the difference between the derivative s fixed contract price and the underlying market price at the determination date. Realized and unrealized gains and losses on derivatives that are not designated as hedges are recorded as an expense. In connection with the Magnum Hunter merger, Cimarex recognized a $39.3 million net liability associated with Magnum Hunter s existing commodity derivatives at the merger date (June 7, 2005). These derivative instruments have not been designated for hedge accounting treatment. As a result, Cimarex recognized in earnings during the second quarter a net loss of $2.0 million. The net derivative liability at June 30, 2005 equals $41.4 million. Cimarex will continue to recognize gains and losses in future earnings until the derivative instruments mature.

*Full Cost Accounting*

We use the full cost method of accounting for our oil and gas operations. All costs associated with property acquisition, exploration and development activities are capitalized. Exploration and development costs include dry hole costs, geological and geophysical costs, direct overhead related to exploration and development activities and other costs incurred for the purpose of finding oil and gas reserves. Salaries and benefits paid to employees directly involved in the exploration and development of properties, as well as other internal costs that can be directly identified with acquisition, exploration and development activities, are also capitalized.

Under full cost accounting rules, capitalized costs, less accumulated amortization and related deferred income taxes, may not exceed an amount equal to the sum of the present value discounted at 10 percent of estimated future net revenues less estimated future expenditures to be incurred in developing and producing the proved reserves, less any related income tax effects. Cash flows used in the calculation of the full cost ceiling limitation are determined based upon estimates of proved oil and gas reserves, future prices, and the costs to extract these reserves. Downward revisions in estimated reserve quantities, increases in future cost estimates or depressed oil and gas prices could cause us to reduce the carrying value of our oil and gas properties. If capitalized costs exceed this limit, the excess must be charged to expense. This is referred to as the full cost ceiling limitation. The expense may not be reversed in future periods, even if higher oil and gas prices subsequently increase the full cost ceiling limitation. At the end of each quarter, a full cost ceiling limitation calculation is made.

*Goodwill*

We account for goodwill in accordance with Statement of Financial Accounting Standard (SFAS) No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 requires an annual impairment assessment. A more frequent assessment is required if certain events occur that reasonably indicate an impairment may have occurred. The volatility of oil and gas prices may cause more frequent assessments. The impairment assessment requires us to make estimates regarding the fair value of the reporting unit. The estimated fair value is based on numerous factors, including future net cash flows of our estimates of proved reserves as well as the success of future exploration for and development of unproved reserves. These factors are each individually weighted to estimate the total fair value of the reporting unit. If the estimated fair value of the reporting unit exceeds its carrying amount, goodwill of the unit is considered not impaired. If the carrying amount exceeds the estimated fair value, then a measurement of the loss must be performed, with any

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deficiency recorded as an impairment. We recorded $45.0 million of goodwill in the purchase of Key on September 30, 2002 and $685.4 million of goodwill in the purchase of Magnum Hunter on June 7, 2005. To date, no related impairment has been recorded.

*Contingencies*

A provision for contingencies is charged to expense when the loss is probable and the cost can be reasonably estimated. Determining when expenses should be recorded for these contingencies and the appropriate amounts for accrual is a complex estimation process that includes subjective judgment. In many cases, this judgment is based on interpretation of laws and regulations, which can be interpreted differently by regulators and/or courts of law. We closely monitor known and potential legal, environmental and other contingencies and periodically determine when we should record losses for these items based on information available to us. As of June 30, 2005, no liabilities have been accrued for known contingencies. See Note 11 of Notes to Consolidated Financial Statements.

*Asset Retirement Obligations*

On January 1, 2003, we adopted SFAS No. 143, *Accounting for Asset Retirement Obligations*. This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The Statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made, and that the associated asset retirement costs be capitalized as part of the carrying amount of the long-lived asset. Oil and gas producing companies incur this liability upon acquiring or drilling a well.

*Stock Options*

For periods prior to January 1, 2005, we applied Accounting Principles Board (APB) Opinion 25, *Accounting for Stock Issued to Employees*, and related interpretations to account for all stock option grants. No compensation cost had been recognized for stock options granted, as the option prices were equal to the market price of the underlying common stock on the date of grant.

Effective January 1, 2005, we adopted the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123R, *Share Based Payment* on a prospective basis. SFAS No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation to employees.

The fair value of each option award is estimated as of the date of grant using the Black-Scholes option-pricing model. Expected volatilities are based on the historical volatility of our common stock. Historical data is also used to estimate option exercise, expected years until exercise and employee termination within the valuation model. The risk free interest rate is based on U.S. Treasury Securities at a constant five year fixed maturity in effect at the date of the grant.

*Recent Accounting Developments*

In May 2005, the Financial Accounting Standards Board ( FASB ) issued Statement 154, *Accounting Changes and Error Corrections*, which requires retrospective application (the application of the changed accounting principle to previously issued financial statements as if that principle had always been used) for voluntary changes in accounting principle unless it is impracticable to do so. Previously the cumulative effect of such changes was recognized in net income of the period of the change. The effective date is for changes made in fiscal year beginning after December 15, 2005.

In June 2005, the Emerging Issues Task Force ( EITF ) issued two Consensuses that are subject to later ratification by the FASB:

The first is EITF 04-5 which establishes a framework for evaluating whether a general partner or a group of general partners controls a limited partnership and therefore should consolidate it. Unless the limited partners have kick-out rights allowing them to dissolve or liquidate the partnership or otherwise remove the general partner without cause , or participating rights allowing the limited partners to participate in significant decisions made in the ordinary course of the partnership s business, the general partner(s) hold effective control and should consolidate the limited partnership. This would be effective immediately for newly-formed limited partnerships and for existing limited partnership agreements that are modified. For existing limited partnership agreements that are not modified, it would be effective for the beginning of the first reporting period after December 15, 2005.

The second Consensus is EITF 05-2 which provides guidance for issuers of debt and preferred-stock instruments with conversion features that may need to be accounted for as derivatives.

Also in June 2005, the FASB issued two proposals. The first, *Business Combinations: a replacement of FASB Statement No. 141,* would extend the purchase method of accounting to combinations that include mutual entities, which are currently accounted for using an as-if pooling method . The proposal would also require costs of an acquisition to be expensed, rather than being included in the purchase price. The second, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries, a replacement of ARB No. 51,* would require parent companies to present noncontrolling interests in subsidiaries as a separate component of equity, not as a liability or as a so-called mezzanine item between liabilities and equity. The proposed statements would be effective for annual periods beginning on or after December 15, 2006.

*Overview*

Our results of operations are impacted by oil and gas prices, which are volatile. Realized oil and gas prices increased from $37.40 per barrel and $5.65 per Mcf in the second quarter of 2004 to $50.56 per barrel and $6.49 per Mcf in the second quarter of 2005. The majority of our revenues are from oil and gas sales, so price fluctuations can significantly affect our financial results.

Gas gathering, marketing and processing revenues net of related costs pertain to activities with third parties conducted by our marketing group. Natural gas sales transactions are conducted with various purchasers under a variety of terms and conditions and supplied by purchasing gas from other producers and marketing companies. For the sales transactions in which the gas is supplied by our own production, related sales and costs are reflected in Cimarex s gas sales and transportation expense.

We also own interests in gas gathering systems and gas processing plants that are largely incidental to our production operations, which also transport and process third party gas.

Transportation expenses are comprised of costs paid to carry and deliver oil and gas to a specified delivery point. In some cases we receive a payment from purchasers, which is net of transportation costs, and in other instances we separately pay for transportation. If costs are netted in the proceeds received, both the revenues and costs are shown gross in sales and expenses, respectively.

Production costs are composed of lease operating expenses, which generally consist of pumpers salaries, utilities, maintenance and other costs necessary to operate our producing properties.

Taxes other than income are taxes assessed by applicable taxing authorities pertaining to production, revenues or the value of our properties. These typically include production severance, ad valorem and excise taxes.

Depreciation, depletion and amortization of our producing properties is computed using the unit-of-production method. Because the economic life of each producing well depends upon the assumed price for production, fluctuations in oil and gas prices may impact the level of proved reserves used in the calculation. Higher prices generally have the effect of increasing reserves, which reduces depletion, while lower prices generally have the effect of decreasing reserves, which increases depletion.

General and administrative expenses consist primarily of salaries and related benefits, office rent, legal fees, consultants, systems costs and other administrative costs incurred in our offices. While we expect such costs to increase with our growth, we expect such increases to be proportionately smaller than our production growth. Expenses related to the merger are costs associated with the Magnum Hunter transaction.

Stock compensation expense consists of non-cash charges resulting from the issuance of restricted stock and restricted stock units to certain employees and the expensing of stock options resulting from the adoption of SFAS No. 123R.

*Basis of Presentation*

Cimarex was formed in February 2002 as a wholly-owned subsidiary of Helmerich & Payne, Inc. (H&P). As a result of a dividend declared and paid by H&P on September 30, 2002, in the form of Cimarex common stock, Cimarex was spun-off and became a stand-alone company. Also on September 30, 2002, Cimarex acquired 100 percent of the outstanding common stock of Key Production Company, Inc. (Key) in a tax-free exchange.

In June 2005, Cimarex acquired Magnum Hunter Resources, Inc, by issuing 0.415 shares of Cimarex common stock for each share of outstanding Magnum Hunter common stock, resulting in the issuance of 39.7 million Cimarex common shares. After closing, the combined company had 82.1 million shares outstanding, and Cimarex stockholders owned 51.6 percent and Magnum Hunter stockholders 48.4 percent. The merger was accounted for as a purchase of Magnum Hunter by Cimarex. The results of operations of Magnum Hunter are included in our consolidated statements of operations for the period since the acquisition on June 7, 2005.

**RESULTS OF OPERATIONS**

**Periods Ended June 30, 2005 Compared with Periods Ended June 30, 2004**

**SUMMARY DATA:**

| (In thousands or as indicated) | For the Three Months Ended June 30, 2005 | 2004 | For the Six Months Ended June 30, 2005 | 2004 |
|---|---|---|---|---|
| Net Income | $ 52,477 | $ 36,470 | $ 95,842 | $ 66,335 |
| Per share-basic | 1.01 | 0.88 | 2.04 | 1.60 |
| Per share-diluted | 0.98 | 0.85 | 1.98 | 1.56 |
| | | | | |
| Gas sales | $ 137,159 | $ 90,864 | $ 243,033 | $ 165,196 |
| Oil sales | 47,862 | 24,450 | 79,370 | 45,628 |
| Total oil and gas sales | $ 185,021 | $ 115,314 | $ 322,403 | $ 210,824 |
| | | | | |
| Total gas volume-MMcf | 21,143 | 16,096 | 38,779 | 30,226 |
| Gas volume-MMcf per day | 232.3 | 176.9 | 214.2 | 166.1 |
| Average gas price-per Mcf | $ 6.49 | $ 5.65 | $ 6.27 | $ 5.47 |
| | | | | |
| Total oil volume-thousand barrels | 947 | 654 | 1,613 | 1,280 |
| Oil volume-barrels per day | 10,402 | 7,184 | 8,911 | 7,035 |
| Average oil price-per barrel | $ 50.56 | $ 37.40 | $ 49.21 | $ 35.64 |
| | | | | |
| Gas gath., mkting.& processing revenues | $ 65,215 | $ 53,831 | 118,951 | $ 90,592 |
| Gas gath., mkting. & processing costs | 63,987 | 53,286 | 117,214 | 89,586 |
| Gas gath., mkting & processing margin | $ 1,228 | $ 545 | $ 1,737 | $ 1,006 |
| | | | | |
| Other revenues | $ 2,222 | $ 1,048 | $ 2,811 | $ 4,696 |
| | | | | |
| Costs and expenses: | | | | |
| Depreciation, depletion and amortization | $ 51,582 | $ 30,834 | $ 89,667 | $ 57,172 |
| Production | 17,412 | 9,419 | 27,583 | 18,888 |
| Transportation | 3,608 | 2,493 | 6,082 | 4,848 |
| Taxes other than income | 13,600 | | | |