

Rosetta Resources Inc.
Form 10-Q
May 15, 2007

**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 31,2007**

OR

Transition Report Pursuant To Section 15(d) of The Securities Exchange Act of 1934

Commission File Number: 000-51801

ROSETTA RESOURCES INC.
(Exact name of registrant as specified in its charter)

Delaware
**(State or other jurisdiction of incorporation or
organization)**

43-2083519
(I.R.S. Employer Identification No.)

717 Texas, Suite 2800, Houston, TX
(Address of principal executive offices)

77002
(Zip Code)

Registrant's telephone number, including area code: **(713) 335-4000**

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Securities Exchange Act of 1934. Large accelerated filer Accelerated filer Non-Accelerated filer

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Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Securities Exchange Act of 1934). Yes No

The number of shares of the registrant's Common Stock, \$.001 par value per share, outstanding as of May 4, 2007 was 50,771,054.

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Rule 13a-14(a) Certification executed by Michael J. Rosinski		
Section 1350 Certification		

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Rosetta Resources Inc.
Consolidated Balance Sheet
(In thousands, except share amounts)

	March 31, 2007 (Unaudited)	December 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	\$ 50,907	\$ 62,780
Accounts receivable	36,774	36,408
Derivative instruments	122	20,538
Deferred income taxes	3,628	-
Prepaid expenses	19,298	8,761
Other current assets	3,444	2,965
Total current assets	114,173	131,452
Oil and natural gas properties, full cost method, of which \$44.1 million at March 31, 2007 and \$37.8 million at December 31, 2006 were excluded from amortization	1,290,739	1,223,337
Other fixed assets	4,888	4,562
	1,295,627	1,227,899
Accumulated depreciation, depletion, and amortization	(175,533)	(145,289)
Total property and equipment, net	1,120,094	1,082,610
Deferred loan fees	3,080	3,375
Other assets	1,105	1,968
Total other assets	4,185	5,343
Total assets	\$ 1,238,452	\$ 1,219,405
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 25,687	\$ 23,040
Accrued liabilities	49,392	43,099
Royalties payable	10,811	9,010
Derivative instruments	9,622	-
Prepayment on gas sales	18,590	17,868
Deferred income taxes	46	7,743
Total current liabilities	114,148	100,760
Long-term liabilities:		
Derivative instruments	17,753	11,014
Long-term debt	240,000	240,000
Asset retirement obligation	11,262	10,253
Deferred income taxes	40,895	35,089
Total liabilities	424,058	397,116
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Common stock, \$0.001 par value; authorized 150,000,000 shares; issued 50,427,523 shares and 50,405,794 shares at March 31, 2007 and December 31, 2006, respectively	50	50

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Additional paid-in capital	756,809	755,343
Treasury stock, at cost; 88,887 and 85,788 shares at March 31, 2007 and December 31, 2006, respectively	(1,620)	(1,562)
Accumulated other comprehensive (loss) income	(16,979)	6,315
Retained earnings	76,134	62,143
Total stockholders' equity	814,394	822,289
Total liabilities and stockholders' equity	\$ 1,238,452	\$ 1,219,405

The accompanying notes to the financial statements are an integral part hereof.

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Rosetta Resources Inc.
Consolidated Statement of Operations
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended	
	March 31,	
	2007	2006
Revenues:		
Natural gas sales	\$ 69,161	\$ 56,735
Oil sales	6,635	7,809
Total revenues	75,796	64,544
Operating Costs and Expenses:		
Lease operating expense	8,796	9,558
Depreciation, depletion, and amortization	30,551	24,067
Treating and transportation	763	895
Marketing fees	663	624
Production taxes	985	1,697
General and administrative costs	8,069	9,251
Total operating costs and expenses	49,827	46,092
Operating income	25,969	18,452
Other (income) expense		
Interest expense, net of interest capitalized	4,370	4,132
Interest income	(972)	(1,137)
Other (income) expense, net	-	25
Total other expense	3,398	3,020
Income before provision for income taxes	22,571	15,432
Provision for income taxes	8,580	5,906
Net income	\$ 13,991	\$ 9,526
Earnings per share:		
Basic	\$ 0.28	\$ 0.19
Diluted	\$ 0.28	\$ 0.19
Weighted average shares outstanding:		
Basic	50,325	50,121
Diluted	50,483	50,355

The accompanying notes to the financial statements are an integral part hereof.

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Rosetta Resources Inc.
Consolidated Statement of Cash Flows
(In thousands)
(Unaudited)

	Three Months Ended	
	March 31,	
	2007	2006
Cash flows from operating activities		
Net income	\$ 13,991	\$ 9,526
Adjustments to reconcile net income to net cash from operating activities		
Depreciation, depletion and amortization	30,551	24,067
Deferred income taxes	8,580	5,906
Amortization of deferred loan fees recorded as interest expense	295	295
Income from unconsolidated investments	(47)	25
Stock compensation expense	1,352	1,835
Change in operating assets and liabilities:		
Accounts receivable	(366)	8,212
Income taxes receivable	-	6,000
Other assets	(10,720)	(4,160)
Accounts payable	2,647	(1,753)
Accrued liabilities	(2,285)	(2,857)
Royalties payable	2,523	(6,081)
Net cash provided by operating activities	46,521	41,015
Cash flows from investing activities		
Purchases of property and equipment	(58,452)	(36,325)
Deposits	-	25
Other	3	111
Net cash used in investing activities	(58,449)	(36,189)
Cash flows from financing activities		
Equity offering transaction fees	-	267
Proceeds from issuances of common stock	114	192
Purchases of treasury stock	(59)	(1,246)
Other	-	(12)
Net cash provided by (used in) financing activities	55	(799)
Net (decrease) increase in cash	(11,873)	4,027
Cash and cash equivalents, beginning of period	62,780	99,724
Cash and cash equivalents, end of period	\$ 50,907	\$ 103,751
Supplemental non-cash disclosures:		
Capital expenditures included in accrued liabilities	\$ 4,397	\$ 2,249

The accompanying notes to the financial statements are an integral part hereof.

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Rosetta Resources Inc.

Notes to Consolidated Financial Statements (unaudited)

(1) Organization and Operations of the Company

Nature of Operations. Rosetta Resources Inc. (together with its consolidated subsidiaries, the “Company”) was formed in June 2005 to acquire Calpine Natural Gas L.P., the domestic oil and natural gas business formerly owned by Calpine Corporation and affiliates (“Calpine”). The Company acquired Calpine Natural Gas L.P. in July 2005 (hereinafter, the “Acquisition”) and together with all subsequently acquired oil and natural gas properties is engaged in oil and natural gas exploration, development, production and acquisition activities in the United States. The Company’s main operations are concentrated in the Sacramento Basin of California, the Lobo and Perdido Trends in South Texas, the State Waters of Texas, the Gulf of Mexico and the Rocky Mountains.

These interim financial statements have not been audited. However, in the opinion of management, all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the financial statements have been included. Results of operations for interim periods are not necessarily indicative of the results of operations that may be expected for the entire year. In addition, these financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all disclosures required for financial statements prepared in conformity with accounting principles generally accepted in the United States of America. These financial statements and notes should be read in conjunction with the Company’s audited Consolidated/Combined Financial Statements and the notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2006.

Certain reclassifications of prior year balances have been made to conform such amounts to corresponding 2007 classifications. These reclassifications have no impact on net income.

(2) Summary of Significant Accounting Policies

The Company has provided discussion of significant accounting policies, estimates and judgments in its Annual Report on Form 10-K for the year ended December 31, 2006.

Principles of Consolidation and Basis of Presentation. The accompanying consolidated financial statements as of March 31, 2007 and December 31, 2006 and for the three months ended March 31, 2007 and 2006 contain the accounts of Rosetta Resources Inc. and its majority owned subsidiaries after eliminating all significant intercompany balances and transactions.

Recent Accounting Developments

The Fair Value Option for Financial Assets and Financial Liabilities. In February 2007, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 159, “The Fair Value Option For Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115” (“SFAS” No. 159), which permits an entity to choose to measure certain financial assets and liabilities at fair value. SFAS No. 159 also revises provisions of SFAS No. 115 that apply to available-for-sale and trading securities. This statement is effective for fiscal years beginning after November 15, 2007. The Company has not yet evaluated the potential impact of this standard.

Fair Value Measurements. In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (“SFAS No. 157”), which addresses how companies should measure fair value when companies are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles (“GAAP”). As a result of

SFAS No. 157, there is now a common definition of fair value to be used throughout GAAP. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those years. The Company is still assessing the impact of this standard but does not expect the adoption of this standard to have a material impact on the Company's consolidated financial position, results of operations, or cash flows.

Accounting for Uncertainty in Income Taxes. In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN 48"). This interpretation addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on derecognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures. The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company did not have any unrecognized tax benefits and there was no effect on the Company's consolidated financial condition, results of operations or cash flows as a result of implementing FIN 48. For additional information see Note 7 to the Consolidated Financial Statements.

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The Company's total property, plant and equipment consist of the following:

	March 31, 2007	December 31, 2006
	(In thousands)	
Proved properties	\$ 1,237,939	\$ 1,170,223
Unproved properties	31,517	35,178
Gas gathering systems and compressor stations	21,283	17,936
Other	4,888	4,562
Total	1,295,627	1,227,899
Less: Accumulated depreciation, depletion, and amortization	(175,533)	(145,289)
	\$ 1,120,094	\$ 1,082,610

The Company capitalizes internal costs directly identified with acquisition, exploration and development activities. The Company capitalized \$1.3 million and \$0.8 million of internal costs for the three months ended March 31, 2007 and 2006, respectively.

Included in the Company's oil and natural gas properties are asset retirement obligations of \$14.5 million and \$9.6 million as of March 31, 2007 and December 31, 2006, respectively.

Oil and natural gas properties include costs of \$44.1 million and \$37.8 million at March 31, 2007 and December 31, 2006, respectively, which were excluded from capitalized costs being amortized. These amounts primarily represent unproved properties and unevaluated exploration projects in which the Company owns a direct interest. The increase in costs excluded during 2007 is primarily related to the increase in exploration activities in Offshore and Texas State Waters.

The Company's ceiling test computation was calculated using hedge adjusted market prices at March 31, 2007 which were based on a Henry Hub price of \$7.34 per MMBtu and a West Texas Intermediate oil price of \$66.20 per Bbl (adjusted for basis and quality differentials). Cash flow hedges of natural gas production in place at March 31, 2007 increased the calculated ceiling value by approximately \$15 million (net of tax). There was no writedown recorded at March 31, 2007. Due to the volatility of commodity prices, should natural gas prices decline in the future, it is possible that a writedown could occur.

In April 2007, the Company acquired properties located in the Sacramento Basin from Output Exploration, LLC and OPEX Energy, LLC at a total purchase price of \$40 million, subject to final adjustments.

(4) Commodity Hedging Contracts and Other Derivatives

In the first quarter of 2007, the Company entered into additional 6,000 MMBtu per day financial fixed price swaps with an average price of \$8.11 per MMBtu covering a portion of the Company's 2007 production. The following financial fixed price swaps were outstanding with associated notional volumes and average underlying prices that represent hedged prices of commodities at various market locations at March 31, 2007:

Settlement Period	Derivative Instrument	Hedge Strategy	Notional Daily	Total of Notional	Average Underlying	Total of Proved	Fair Market
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			Volume MMBtu	Volume MMBtu	Prices MMBtu	Natural Gas Production Hedged (1)	Value Gain (In thousands)
2007	Swap	Cash flow	55,327	15,215,000	\$7.80	45%	(2,245)
2008	Swap	Cash flow	49,909	18,266,616	\$7.62	44%	(15,007)
2009	Swap	Cash flow	26,141	9,541,465	\$6.99	26%	(10,233)
				43,023,081			\$ (27,485)

(1) Estimated based on net gas reserves presented in the December 31, 2006 Netherland, Sewell, & Associates, Inc. reserve report.

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The following costless collar transactions were outstanding with associated notional volumes and contracted ceiling and floor prices that represent hedge prices at various market locations at March 31, 2007:

Settlement Period	Derivative Instrument	Hedge Strategy	Notional Daily Volume MMBtu	Total of Notional Volume MMBtu	Average Floor Price MMBtu	Average Ceiling Price MMBtu	Total of Proved Natural Gas Production Hedged (1)	Fair Market Value Gain (In thousands)
2007	Costless Collar	Cash flow	10,000	2,750,000	\$ 7.19	\$ 10.03	8%	\$ 232
				2,750,000				\$ 232

(1) Estimated based on net gas reserves presented in the December 31, 2006 Netherland, Sewell, & Associates, Inc. reserve report.

The Company's current cash flow hedge positions are with counterparties who are lenders in the Company's credit facilities. This eliminates the need for independent collateral postings with respect to any margin obligation resulting from a negative change in fair market value of the derivative contracts in connection with the Company's hedge related credit obligations. As of March 31, 2007, the Company made no deposits for collateral.

The following table sets forth the results of third party hedge transactions for the respective period for the Consolidated Statement of Operations:

Natural Gas	Three Months Ended March 31,	
	2007	2006
Quantity settled (MMBtu)	5,499,500	4,950,000
Increase in natural gas sales revenue (In thousands)	\$ 5,044	\$ 1,563

The Company expects to reclassify losses of \$5.9 million based on market pricing as of March 31, 2007 to earnings from the balance in accumulated other comprehensive income (loss) on the Consolidated Balance Sheet during the next twelve months.

At March 31, 2007, the Company had derivative assets of \$0.1 million on the Consolidated Balance Sheet. The Company also had derivative liabilities of \$27.4 million of which \$17.8 million is included in long-term liabilities on the Consolidated Balance Sheet at March 31, 2007. The derivative instrument assets and liabilities relate to commodity hedges that represent the difference between hedged prices and market prices on hedged volumes of the commodities as of March 31, 2007. Hedging activities related to cash settlements on commodities increased revenues by \$5.0 million and \$1.6 million for the three months ended March 31, 2007 and 2006.

Gains and losses related to ineffectiveness and derivative instruments not designated as hedging instruments are included in other income (expense) and were immaterial for the three months ended March 31, 2007 and 2006.

In April 2007, the Company entered into two additional financial fixed price swaps with prices ranging from \$7.25 per MMBtu to \$8.63 per MMBtu for a total of 5,000 MMBtu per day covering a portion of the Company's 2008 production.

(5) Asset Retirement Obligation

Activity related to the Company's asset retirement obligation ("ARO") is as follows:

	Three Months Ended March 31, 2007 (In thousands)	
ARO as of January 1, 2007	\$	10,689
Revision of previous estimates		4,697
Liabilities incurred during period		187
Accretion expense		289
ARO as of March 31, 2007	\$	15,862

Of the total ARO, approximately \$4.6 million is classified as a current liability at March 31, 2007.

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(6) Long-Term Debt

The Company's credit facilities consist of a four-year senior secured revolving line of credit ("Revolver") of up to \$400.0 million with a borrowing base of \$325.0 million and a five-year \$75.0 million second lien term loan.

On March 31, 2007, the Company had outstanding borrowings and letters of credit of \$240.0 million and \$1.0 million, respectively. Net borrowing availability was \$159.0 million at March 31, 2007. The Company was in compliance with all covenants at March 31, 2007.

In May 2007, the borrowing base of the Revolver was adjusted to \$350.0 million. All amounts drawn under the Revolver are due and payable on July 7, 2009. The principal balance associated with the second lien term loan is due and payable on July 7, 2010.

(7) Income Tax

The Company did not have any unrecognized tax benefits and there was no effect on the Company's consolidated financial condition, results of operations or cash flows as a result of implementing FIN 48. The amount of unrecognized tax benefits did not materially change as of March 31, 2007.

The Company files a federal income tax return in the United States Federal jurisdiction and various filings in several state and local jurisdictions. The Company began operations in 2005, and therefore is not subject to U.S. Federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2005.

Estimated interest and penalties related to potential underpayment on any unrecognized tax benefits are classified as a component of tax expense in the Consolidated Statement of Operations. As of the date of adoption of FIN 48, the Company did not have any accrued interest or penalties associated with any unrecognized tax benefits, nor was any interest expense recognized during the quarter.

The Company's effective tax rate differs from the federal statutory rate primarily due to state taxes, tax credits and other permanent differences. The Company does not anticipate that total unrecognized tax benefits will significantly change due to the settlement of audits and the expiration of statute of limitations prior to March 31, 2008.

(8) Commitment and Contingencies

The Company is party to various oil and natural gas litigation matters arising out of the normal course of business. The ultimate outcome of each of these matters cannot be absolutely determined, and the liability the Company may ultimately incur with respect to any one of these matters in the event of a negative outcome may be in excess of amounts currently accrued for with respect to such matters. Management does not believe any such matters will have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

Calpine Bankruptcy

Calpine Corporation and certain of its subsidiaries filed for protection under the federal bankruptcy laws in the United States Bankruptcy Court of the Southern District of New York (the "Bankruptcy Court") on December 20, 2005. Calpine Energy Services, L.P., which filed for bankruptcy, has continued to make the required deposits into the Company's margin account and to timely pay for natural gas production it purchases from the Company's subsidiaries under various natural gas supply agreements. Additionally, Calpine Producer Services, L.P., which filed for bankruptcy, is under contract through June 30, 2007 with the Company and is generally performing its obligations under the Marketing and Services Agreement.

There remains the possibility, however, that there will be issues between the Company and Calpine that could amount to material contingencies in relation to the Purchase and Sale Agreement and interrelated agreements concurrently executed therewith, dated July 7, 2005, by and among Calpine, the Company, and various other signatories thereto (collectively, the "Purchase Agreement"), including unasserted claims and assessments with respect to (i) the still pending Purchase Agreement and the amounts that will be payable in connection therewith, (ii) whether or not Calpine and its affiliated debtors will, in fact, perform their remaining obligations in connection with the Purchase Agreement; and (iii) the ultimate disposition of the remaining Non-Consent Properties (and related royalty revenues). Calpine has specific obligations to the Company under the Purchase Agreement relating to these matters, and also has "further assurances" duties to the Company under the Purchase Agreement.

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In addition, as to certain of the other oil and natural gas properties the Company purchased from Calpine in the Acquisition and for which payment was made on July 7, 2005, the Company will seek additional documentation from Calpine to eliminate any open issues in the Company's title or resolve any issues as to the clarity of the Company's ownership. Requests for additional documentation are customary in connection with transactions similar to the Acquisition. In the Acquisition, certain of these properties require ministerial governmental action approving the Company as qualified assignee and operator, which is typically required even though in most cases Calpine has already conveyed the properties to the Company free and clear of mortgages and liens by Calpine's creditors. As to certain other properties, the documentation delivered by Calpine at closing under the Purchase Agreement was incomplete. The Company remains hopeful that Calpine will work cooperatively with the Company to secure these ministerial governmental approvals and to accomplish the curative corrections for all of these properties. In addition, as to all properties acquired by the Company in the Acquisition, Calpine contractually agreed to provide the Company with such further assurances as the Company may reasonably request. Nevertheless, as a result of Calpine's bankruptcy filing, it remains uncertain as to whether Calpine will respond cooperatively. If Calpine does not fulfill its contractual obligations and does not complete the documentation necessary to resolve these issues, the Company will pursue all available remedies, including but not limited to a declaratory judgment to enforce the Company's rights and actions to quiet title. After pursuing these matters, if the Company experiences a loss of ownership with respect to these properties without receiving adequate consideration for any resulting loss to the Company, an outcome the Company's management considers to be remote, then the Company could experience losses which could have a material adverse effect on the Company's consolidated financial condition, statement of operations and cash flows.

On June 29, 2006, Calpine filed a motion in connection with its pending bankruptcy proceeding in the Bankruptcy Court seeking the entry of an order authorizing Calpine to assume certain oil and natural gas leases that Calpine had previously sold or agreed to sell to the Company in the Acquisition, to the extent those leases constitute "unexpired leases of non-residential real property" and were not fully transferred to the Company at the time of Calpine's filing for bankruptcy. According to this motion, Calpine filed in order to avoid the automatic forfeiture of any interest it may have in these leases by operation of a statutory deadline. Calpine's motion did not request that the Bankruptcy Court determine whether these properties belong to the Company or Calpine, but the Company understands it was meant to allow Calpine to preserve and avoid forfeiture under the Bankruptcy Code of whatever interest Calpine may possess, if any, in these oil and natural gas leases. The Company disputes Calpine's contention that it may have an interest in any significant portion of these oil and natural gas leases and intends to take the necessary steps to protect all of the Company's rights and interest in and to the leases. On July 7, 2006, the Company filed an objection in response to Calpine's motion, wherein the Company asserted that oil and natural gas leases constitute interests in real property that are not subject to "assumption" under the Bankruptcy Code. In the objection, the Company also requested that (a) the Bankruptcy Court eliminate from the order certain Federal offshore leases from the Calpine motion because these properties were fully conveyed to the Company in July 2005, and the Minerals Management Service has subsequently recognized the Company as owner and operator of all but three of these properties, and (b) any order entered by the Bankruptcy Court be without prejudice to, and fully preserve the Company's rights, claims and legal arguments regarding the characterization and ultimate disposition of the remaining described oil and natural gas properties. In the Company's objection, the Company also urged the Bankruptcy Court to require the parties to promptly address and resolve any remaining issues under the pre-bankruptcy definitive agreements with Calpine and proposed to the Bankruptcy Court that the parties seek arbitration (or at least mediation) to complete the following:

- Calpine's conveyance of the Non-Consent Properties to the Company;
- Calpine's execution of all documents and performance of all tasks required under "further assurances" provisions of the Purchase Agreement with respect to certain of the oil and natural gas properties for which the Company has already paid Calpine; and
-

Resolution of the final amounts the Company is to pay Calpine, which the Company has concluded is approximately \$79 million, consisting of roughly \$68 million for the Non-Consent Properties and approximately \$11 million in other true-up payment obligations.

At a hearing held on July 12, 2006, the Bankruptcy took the following steps:

- In response to an objection filed by the Department of Justice and asserted by the California State Lands Commission that the Debtors' Motion to Assume Non-Residential Leases and Set Cure Amounts (the "Motion"), did not allow adequate time for an appropriate response, Calpine withdrew from the list of Oil and Gas Leases that were the subject of the Motion those leases issued by the United States (and managed by the Minerals Management Service of the United States Department of Interior) (the "MMS Oil and Gas Leases") and the State of California (and managed by the California State Lands Commission) (the "CSLC Leases"). Calpine and both the Department of Justice and the State of California agreed to an extension of the existing deadline to November 15, 2006 to assume or reject the MMS Oil and Gas Leases and CSLC Leases under Section 365 of the Bankruptcy Code, to the extent the MMS Oil and Gas Leases and CSLC Leases are leases subject to Section 365. The effect of these actions was to render the objection of the Company inapplicable at that time; and

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- The Bankruptcy Court also encouraged Calpine and the Company to arrive at a business solution to all remaining issues including approximately \$68 million payable to Calpine for conveyance of the Non-Consent Properties.

On August 1, 2006, the Company filed a number of proofs of claim in the Calpine bankruptcy asserting claims against a variety of Calpine debtors seeking recovery of \$27.9 million in liquidated amounts as well as unliquidated damages in amounts that can not presently be determined. The Company continues to work with Calpine on a cooperative and expedited basis toward resolution of unresolved conveyance of properties and post closing adjustments under the Purchase Agreement.

With respect to the stipulations between Calpine and MMS and Calpine and CSLC extending the deadline to assume or reject the MMS Oil and Gas Leases, these parties have further extended this deadline time by stipulation. The deadline was first extended to January 31, 2007, then was further extended to April 15, 2007 with respect to the MMS Oil and Gas Leases and April 30, 2007 with respect to the CSLC Leases, and recently was further extended to September 15, 2007 with respect to the MMS Oil and Gas Leases and July 15, 2007 with respect to the CSLC Leases. The Bankruptcy Court entered Orders related to the MMS Oil and Gas Leases and CSLC Leases which included appropriate language that the Company negotiated with Calpine for protection in this regard.

Recently, Calpine sought and obtained an extension to June 20, 2007 from the Bankruptcy Court for the period in which only Calpine, exclusively, may file its plan of reorganization. While there is no assurance that Calpine will file a plan of reorganization by this deadline, or that such a plan will be approved by the creditors and the Bankruptcy Court, the Company remains optimistic that the issues involving conclusion of the remaining conveyances of the Non-Consent Properties and obtaining the further assurances from Calpine under the Purchase Agreement, including perhaps resolution of any and all claims, may occur during 2007.

Calpine recently requested Bankruptcy Court approval of a new credit facility which would require it to grant liens to these new lenders in all of its assets, including any interest it may still hold in any oil and natural gas properties it obligated itself to convey to the Company under the Purchase Agreement. The Bankruptcy Court entered an Order approving Calpine's ability to obtain this new loan which includes appropriate language that the Company negotiated with Calpine for the Company's protection in this regard.

Furthermore, there can be no assurance that Calpine, its creditors or other interest holders will not challenge the fairness of the Acquisition. For a number of reasons, including the Company's understanding of the process that Calpine followed in allowing market forces to set the purchase price for the Acquisition, the Company believes that it is unlikely that any challenges by the Calpine debtors or their creditors to the overall fairness of the Acquisition would be successful. The Company will take all necessary action to ensure the Company's rights under the Purchase agreement, the MMS Oil and Gas Leases, the CSLC Leases and the Bankruptcy Code are fully protected.

Arbitration between Calpine Corp./RROLP and Pogo Producing Company

On September 1, 2004, Calpine and Calpine Natural Gas L.P. sold their New Mexico oil and natural gas assets to Pogo Producing Company ("Pogo"). During the course of the sale, Pogo made three title defect claims on properties sold by Calpine (valued at approximately \$2.7 million in the aggregate, subject to a \$0.5 million deductible assuming no reconveyance) claiming, that certain leases subject to the sale had expired because of lack of production. Calpine had undertaken without success to resolve this matter by obtaining ratifications of a majority of the questionable leases. Calpine filed for bankruptcy protection before Pogo filed arbitration against it. Even though this is a retained liability of Calpine, Calpine declined to accept the Company's tender of defense and indemnity when Pogo filed for arbitration against the Company. The Company filed a motion to stay this arbitration under the automatic stay provision of the Bankruptcy Code which motion was granted by the Bankruptcy Court on April 24, 2007 for a period of time of the earlier of fifteen months from the date of entry of the stay order or the effective date of a final order

confirming Calpine's plan of reorganization. This is a retained liability by the Company and it is too early for management to determine whether this matter will have any financial impact to the Company.

Environmental

Environmental expenditures are expensed or capitalized, as appropriate, depending on their future economic benefit. Expenditures that relate to an existing condition caused by past operations, and that do not have future economic benefit, are expensed. Liabilities related to future costs are recorded on an undiscounted basis when environmental assessments and/or remediation activities are probable and the cost can be reasonably estimated. The Company performed an environmental remediation study for two sites in California and correspondingly, recorded a liability, which at March 31, 2007 and December 31, 2006 was \$0.1 million. The Company does not expect that the outcome of environmental matters discussed above will have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

Table of Contents***Participation in a Regional Carbon Sequestration Partnership***

The Company has made preliminary preparations in connection with its participating in the United States Department of Energy's ("DOE") Regional Carbon Sequestration Partnership program ("WESTCARB") with the California Energy Commission and the University of California Lawrence Berkeley Laboratory. The Company has been selected by the DOE for this project. Under WESTCARB, the Company would be required to drill a carbon injection well, recondition an idle well for use as an observation well and provide WESTCARB with certain proprietary well data and technical assistance related to the evaluation and injection of carbon dioxide into a suitable natural gas reservoir in the Sacramento Basin. The Company's maximum contribution to WESTCARB is \$1.0 million and will be limited to 20% of the total contributions to the project. The Company will not have any obligation under the WESTCARB project until it has entered into an acceptable contract and the project has obtained proper and necessary local, state and federal regulatory approvals, land use authorizations and third party property rights. No accrual was recorded at March 31, 2007 or December 31, 2006 as the study is still in the preliminary stage.

(9) Comprehensive Income

The Company's total comprehensive income (loss) is shown below.

	Three Months Ended March 31, 2007		Three Months Ended March 31, 2006	
	(In thousands)			
Accumulated other comprehensive income (loss) - beginning of period		\$ 6,315		\$ (50,731)
Net income	13,991		9,526	
Change in fair value of derivative hedging instruments	(21,497)		51,750	
Hedge settlements reclassified to income	5,044		(1,563)	
Tax provision related to hedges	(6,841)		(19,071)	
Total other comprehensive (loss) income	(23,294)	(23,294)	31,116	31,116
Comprehensive (loss) income	(9,303)		40,642	
Accumulated other comprehensive loss		\$ (16,979)		\$ (19,615)

(10) Earnings Per Share

Basic earnings per share is computed by dividing income available to common stockholders by the weighted average number of shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if contracts to issue common stock and related stock options were exercised at the end of the period.

The following is a calculation of basic and diluted weighted average shares outstanding:

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	Three Months Ended March 31,	
	2007	2006
	(In thousands)	
Basic weighted average number of shares outstanding	50,325	50,121
Dilution effect of stock option and awards at the end of the period	158	234
Diluted weighted average number of shares outstanding	50,483	50,355
Stock awards and shares excluded from diluted earnings per share due to anti-dilutive effect	435	103

(11) Geographic Area Information

The Company owns oil and natural gas interests in eight main geographic areas all within the United States or its territorial waters. Geographic revenue and property, plant and equipment information below are based on physical location of the assets at the end of each period.

Oil and Natural Gas Revenue

	Three Months Ended March 31,	
	2007 (1)	2006 (1)
	(In thousands)	
California	\$ 27,092	\$ 20,396
Lobo	24,876	15,408
Perdido	5,768	9,822
State Waters	809	3,148
Other Onshore	4,403	3,860
Gulf of Mexico	5,474	9,526
Rockies	1,526	342
Mid-Continent	804	479
	\$ 70,752	\$ 62,981

(1) Excludes the effects of hedging.

Oil and Natural Gas Properties

	March 31, 2007	December 31, 2006
	(In thousands)	
California	\$ 445,501	\$ 435,167
Lobo	449,028	426,348
Perdido	59,673	52,702
State Waters	34,453	26,922

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Other Onshore	106,222	102,734
Gulf of Mexico	131,251	125,425
Rockies	52,527	44,455
Mid-Continent	12,084	9,584
Other	4,888	4,562
	\$ 1,295,627	\$ 1,227,899

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report includes various “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements other than statements of historical fact included or incorporated by reference in this report are forward-looking statements, including without limitation all statements regarding future plans, business objectives, strategies, expected future financial position or performance, expected future operational position or performance, budgets and projected costs, future competitive position, or goals and/or projections of management for future operations. In some cases, you can identify a forward-looking statement by terminology such as “may”, “will”, “could”, “should”, “expect”, “plan”, “project”, “intend”, “anticipate”, “believe”, “estimate”, “predict”, “potential”, “pursue”, “target” or “continue”, the negative of such terms or variations thereon, or other comparable terminology.

The forward-looking statements contained in this report are largely based on our expectations for the future, which reflect certain estimates and assumptions made by our management. These estimates and assumptions reflect our best judgment based on currently known market conditions, operating trends, and other factors. Although we believe such estimates and assumptions to be reasonable, they are inherently uncertain and involve a number of risks and uncertainties that are beyond our control. As such, management’s assumptions about future events may prove to be inaccurate. For a more detailed description of the risks and uncertainties involved, see Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2006 as updated by this report. We do not intend to publicly update or revise any forward-looking statements as a result of new information, future events, changes in circumstances, or otherwise. These cautionary statements qualify all forward-looking statements attributable to us, or persons acting on our behalf. Management cautions all readers that the forward-looking statements contained in this report are not guarantees of future performance, and we cannot assure any reader that such statements will be realized or that the events and circumstances they describe will occur. Factors that could cause actual results to differ materially from those anticipated or implied in the forward-looking statements herein include, but are not limited to:

- The supply and demand for oil, natural gas, and other products and services;
- The price of oil, natural gas, and other products and services;
- Conditions in the energy markets;
- Changes or advances in technology;
- Reserve levels;
- Currency exchange rates and inflation;
- The availability and cost of relevant raw materials, goods and services;
- Commodity prices;
- Future processing volumes and pipeline throughput;
- Conditions in the securities and/or capital markets;
- The occurrence of property acquisitions or divestitures;
- Drilling and exploration risks;

- The availability and cost of processing and transportation;
- Developments in oil-producing and natural gas-producing countries;
- Competition in the oil and natural gas industry;
- The ability and willingness of our current or potential counterparties or vendors to enter into transactions with us and/or to fulfill their obligations to us;
- Our ability to access the capital markets on favorable terms or at all;
- Our ability to obtain credit and/or capital in desired amounts and/or on favorable terms;
- Present and possible future claims, litigation and enforcement actions;

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- Effects of the application of applicable laws and regulations, including changes in such regulations or the interpretation thereof ;
- Relevant legislative or regulatory changes, including retroactive royalty or production tax regimes, changes in environmental regulation, environmental risks and liability under federal, state and foreign environmental laws and regulations;
- General economic conditions, either internationally, nationally or in jurisdictions affecting our business;
- The amount of resources expended in connection with Calpine's bankruptcy, including costs for lawyers, consultant experts and related expenses, as well as all lost opportunity costs associated with our internal resources dedicated to these matters;
- Disputes with mineral lease and royalty owners regarding calculation and payment of royalties;