

PETROHAWK ENERGY CORP

Form 10-K/A

April 02, 2009

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A

(Amendment No. 1)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2008

Commission file number 001-33334

PETROHAWK ENERGY CORPORATION

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of

86-0876964
(I.R.S. Employer

incorporation or organization)

Identification Number)

1000 Louisiana, Suite 5600, Houston, Texas 77002

(Address of principal executive offices including ZIP code)

(832) 204-2700

(Registrant's telephone number)

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

Title of each class

Name of each exchange

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Common Stock, par value \$.001 per share

**on which registered
New York Stock Exchange**

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☒ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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 and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

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

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☐
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒

The aggregate market value of common stock, par value \$.001 per share, held by non-affiliates (based upon the closing sales price on the New York Stock Exchange on June 30, 2008), the last business day of registrant's most recently completed second fiscal quarter was approximately \$10.0 billion.

As of February 20, 2009, there were 252,448,890 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Information required by Part III, Items 10, 11, 12, 13 and 14, is incorporated by reference to portions of the registrant's definitive proxy statement for its 2009 annual meeting of stockholders which will be filed on or before April 30, 2009.

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EXPLANATORY NOTE

Petrohawk Energy Corporation, or the Company, is filing this Amendment No. 1 to its Annual Report on Form 10-K for the year ended December 31, 2008 for the sole purpose of correcting the inadvertent omission of the conformed signature of Deloitte & Touche LLP on the Report of Independent Registered Public Accounting Firm. A manually signed report by Deloitte & Touche LLP was actually delivered to the Company prior to the filing of the Company's Form 10-K on February 25, 2009.

As required by the rules of the U.S. Securities and Exchange Commission, this amended Form 10-K includes the entire text of Item 8 of Part II and Item 15 of Part IV (amended for the sole purpose of including new officer certifications and new consents as Exhibits in accordance with the rules of the U.S. Securities and Exchange Commission). This Amendment does not change, modify or update any of the information in the Form 10-K filed on February 25, 2009, except as noted above.

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MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of Petrohawk Energy Corporation (the "Company"), including the Company's Chief Executive Officer and Chief Financial Officer, is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. The Company's internal control system was designed to provide reasonable assurance to the Company's Management and Directors regarding the preparation and fair presentation of published financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management conducted an evaluation of the effectiveness of internal control over financial reporting based on the *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that Petrohawk Energy Corporation's internal control over financial reporting was effective as of December 31, 2008.

Deloitte & Touche LLP, the Company's independent registered public accounting firm, has issued an attestation report on the effectiveness of our internal control over financial reporting as of December 31, 2008 which is included in Item 8. *Consolidated Financial Statements and Supplementary Data*.

/s/ FLOYD C. WILSON
Floyd C. Wilson
Chairman of the Board, President

and Chief Executive Officer

Houston, Texas

February 25, 2009

/s/ MARK J. MIZE
Mark J. Mize
Executive Vice President,

Chief Financial Officer and Treasurer

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Petrohawk Energy Corporation

Houston, Texas

We have audited the accompanying consolidated balance sheets of Petrohawk Energy Corporation and subsidiaries (the "Company") as of December 31, 2008 and 2007, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2008. We also have audited the Company's internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Petrohawk Energy Corporation and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ DELOITTE & TOUCHE LLP

Houston, Texas

February 24, 2009

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PETROHAWK ENERGY CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

	Years Ended December 31,		
	2008	2007	2006
Operating revenues:			
Oil and gas	\$ 1,031,657	\$ 883,405	\$ 587,762
Marketing	63,553		
Total operating revenues	1,095,210	883,405	587,762
Operating expenses:			
Marketing	58,581		
Production:			
Lease operating	52,477	64,666	58,029
Workover and other	5,624	7,700	8,118
Taxes other than income	47,104	58,347	45,547
Gathering, transportation and other	47,309	33,015	16,187
General and administrative	74,810	73,867	44,069
Depletion, depreciation and amortization	396,556	395,161	261,272
Full cost ceiling impairment	950,799		
Total operating expenses	1,633,260	632,756	433,222
(Loss) income from operations	(538,050)	250,649	154,540
Other income (expenses):			
Net gain (loss) on derivative contracts	156,870	(35,011)	124,442
Interest expense and other	(151,825)	(129,603)	(89,884)
Total other income (expenses)	5,045	(164,614)	34,558
(Loss) income before income taxes	(533,005)	86,035	189,098
Income tax benefit (provision)	144,953	(33,138)	(72,535)
Net (loss) income	(388,052)	52,897	116,563
Preferred dividends			(217)
Net (loss) income available to common stockholders	\$ (388,052)	\$ 52,897	\$ 116,346
Net (loss) income per share of common stock:			
Basic	\$ (1.77)	\$ 0.31	\$ 0.95
Diluted	\$ (1.77)	\$ 0.31	\$ 0.92
Weighted average shares outstanding:			
Basic	218,993	168,006	122,452
Diluted	218,993	171,248	126,135

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

Table of Contents**PETROHAWK ENERGY CORPORATION****CONSOLIDATED BALANCE SHEETS***(In thousands, except share and per share amounts)*

	December 31,	
	2008	2007
Current assets:		
Cash	\$ 6,883	\$ 1,812
Marketable securities	123,009	
Accounts receivable	277,349	148,138
Current portion of deferred income taxes		5,855
Receivables from derivative contracts	201,128	12,369
Prepays and other	40,063	21,019
Total current assets	648,432	189,193
Oil and gas properties (full cost method):		
Evaluated	4,894,357	3,247,304
Unevaluated	2,287,968	677,565
Gross oil and gas properties	7,182,325	3,924,869
Less accumulated depletion	(2,111,038)	(769,197)
Net oil and gas properties	5,071,287	3,155,672
Other operating property and equipment:		
Gas gathering systems and equipment	190,054	1,514
Other operating assets	20,271	17,426
Gross other operating property and equipment	210,325	18,940
Less accumulated depreciation	(11,106)	(6,838)
Net other operating property and equipment	199,219	12,102
Other noncurrent assets:		
Goodwill	933,058	933,945
Debt issuance costs, net of amortization	30,477	12,052
Receivables from derivative contracts	23,399	
Restricted cash (Note 2)		269,837
Note receivable (Note 2)		96,098
Other	1,457	3,540
Total assets	\$ 6,907,329	\$ 4,672,439
Current liabilities:		
Accounts payable and accrued liabilities	\$ 639,432	\$ 331,471
Current portion of deferred income taxes	77,454	
Liabilities from derivative contracts		28,198
Current portion of long-term debt	9,426	828
Total current liabilities	726,312	360,497

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Long-term debt	2,283,874	1,595,127
Liabilities from derivative contracts		6,915
Asset retirement obligations	28,644	23,800
Deferred income taxes	460,913	674,968
Other noncurrent liabilities	2,676	2,235
Commitments and contingencies (Note 6)		
Stockholders' equity:		
Common stock: 300,000,000 shares of \$.001 par value authorized; 252,364,143 and 171,220,817 shares issued and outstanding at December 31, 2008 and 2007, respectively	252	171
Additional paid-in capital	3,655,500	1,871,516
(Accumulated deficit) retained earnings	(250,842)	137,210
Total stockholders' equity	3,404,910	2,008,897
Total liabilities and stockholders' equity	\$ 6,907,329	\$ 4,672,439

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

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PETROHAWK ENERGY CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(In thousands)

	Preferred		Common		Additional	Treasury	(Accumulated Deficit)	Total
	Shares	Amount	Shares	Amount	Paid-in Capital	Stock	Retained Earnings	Stockholders Equity
Balances at December 31, 2005	593	\$ 1	73,566	\$ 74	\$ 558,452	\$ (36)	\$ (32,033)	\$ 526,458
Equity compensation vesting					10,618			10,618
Common stock issued for purchase of KCS Energy, Inc.			83,862	84	1,146,518			1,146,602
Sale of common stock			13,000	13	188,487			188,500
Encap shares retired			(3,322)	(3)	(46,197)			(46,200)
Preferred stock dividends							(217)	(217)
Repurchase of preferred stock	(593)	(1)			(5,487)			(5,488)
Retirement of treasury shares			(8)		(36)	36		
Common stock issuances			1,389	1	2,449			2,450
Offering costs					(10,942)			(10,942)
Net income							116,563	116,563
Balances at December 31, 2006		\$	168,487	\$ 169	\$ 1,843,862	\$	\$ 84,313	\$ 1,928,344
Equity compensation vesting					22,230			22,230
Warrants exercised			575					
Common stock issuances			2,159	2	2,427			2,429
Tax benefit from exercise of stock options					2,997			2,997
Net income							52,897	52,897
Balances at December 31, 2007		\$	171,221	\$ 171	\$ 1,871,516	\$	\$ 137,210	\$ 2,008,897
Sale of common stock			78,200	78	1,831,872			1,831,950
Equity compensation vesting					16,279			16,279
Warrants exercised			1,222	1	883			884
Common stock issuances			1,874	2	13,661			13,663
Purchase of shares to cover individuals tax withholding			(153)		(3,798)			(3,798)
Reduction in shares to cover individuals tax withholding					(1,150)			(1,150)
Offering costs					(73,763)			(73,763)
Net loss							(388,052)	(388,052)
Balances at December 31, 2008		\$	252,364	\$ 252	\$ 3,655,500	\$	\$ (250,842)	\$ 3,404,910

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

Table of Contents**PETROHAWK ENERGY CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS***(In thousands)*

	Years Ended December 31,		
	2008	2007	2006
Cash flows from operating activities:			
Net (loss) income	\$ (388,052)	\$ 52,897	\$ 116,563
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Depletion, depreciation and amortization	396,556	395,161	261,272
Full cost ceiling impairment	950,799		
Income tax (benefit) provision	(144,953)	33,138	72,535
Stock-based compensation	12,310	15,540	8,242
Net unrealized (gain) loss on derivative contracts	(230,640)	79,011	(134,428)
Net realized (gain) loss on derivative contracts acquired		(3,615)	14,646
Other	4,552	5,664	1,469
Change in assets and liabilities, net of acquisitions:			
Accounts receivable	(110,479)	18,554	(16,664)
Prepaid expenses and other	(19,044)	(3,372)	(6,373)
Accounts payable and accrued liabilities	135,382	11,846	(19,231)
Other	2,524	221	(1,138)
Net cash provided by operating activities	608,955	605,045	296,893
Cash flows from investing activities:			
Oil and gas capital expenditures	(3,121,736)	(1,253,180)	(483,372)
Acquisition of One Tec, LLC, net of cash acquired of \$2,145		(39,910)	
Acquisition of KCS Energy, Inc., net of cash acquired of \$8,260			(512,344)
Acquisition of Winwell Resources, Inc., net of cash acquired of \$14,965			(177,264)
Proceeds received from sale of oil and gas properties	109,268	689,220	192,424
Marketable securities purchased	(3,777,427)		
Marketable securities redeemed	3,654,418		
Increase in restricted cash		(650,000)	
Decrease in restricted cash	269,837	380,163	
Other operating property and equipment expenditures	(164,810)	(2,998)	(2,773)
Other		9	10,763
Net cash used in investing activities	(3,030,450)	(876,696)	(972,566)
Cash flows from financing activities:			
Proceeds from exercise of options and warrants	14,438	6,058	2,850
Proceeds from issuance of common stock	1,831,950		188,500
Acquisition of common stock			(46,200)
Offering costs	(73,763)		(10,942)
Proceeds from borrowings	2,764,000	950,000	1,681,183
Repayment of borrowings	(2,086,266)	(689,601)	(1,111,644)
Debt issue costs	(23,793)	(834)	(14,438)
Net realized gain (loss) on derivative contracts acquired		3,615	(14,646)
Buyback of 8% cumulative preferred stock			(5,340)
Other		(1,368)	(968)

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Net cash provided by financing activities	2,426,566	267,870	668,355
Net increase (decrease) in cash	5,071	(3,781)	(7,318)
Cash at beginning of period	1,812	5,593	12,911
Cash at end of period	\$ 6,883	\$ 1,812	\$ 5,593

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

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PETROHAWK ENERGY CORPORATION

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT EVENTS AND ACCOUNTING POLICIES

Basis of Presentation and Principles of Consolidation

Petrohawk Energy Corporation (Petrohawk or the Company) is an independent oil and natural gas company engaged in the exploration, development and production of oil and natural gas properties located in onshore North America. The Company operates in one segment, oil and natural gas exploration and exploitation. The consolidated financial statements include the accounts of all majority-owned, controlled subsidiaries. All intercompany accounts and transactions have been eliminated. Certain prior year amounts have been reclassified to conform to the current year presentation.

Use of Estimates

The preparation of the Company's consolidated financial statements in conformity with accounting principles generally accepted in the United States requires the Company's management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities, if any, at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the respective reporting periods. These estimates include oil and natural gas proved reserve quantities which form the basis for the calculation of amortization of oil and natural gas properties. Management emphasizes that reserve estimates are inherently imprecise and that estimates of more recent reserve discoveries are more imprecise than those for properties with long production histories. Actual results may differ from the estimates and assumptions used in the preparation of the Company's consolidated financial statements.

Marketable Securities

During the second quarter of 2008, the Company made the decision to invest a portion of its cash in money market mutual funds which are highly liquid marketable securities. The Company accounts for marketable securities in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities* and classifies marketable securities as trading, available-for-sale, or held-to-maturity. The appropriate classification of its marketable securities is determined at the time of purchase and reevaluated at each balance sheet date.

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

Allowance for Doubtful Accounts

The Company establishes provisions for losses on accounts receivable if it determines that it will not collect all or part of the outstanding balance. The Company regularly reviews collectibility and establishes or adjusts the allowance as necessary using the specific identification method. There is no significant allowance for doubtful accounts at December 31, 2008 or 2007.

Oil and Natural Gas Properties

The Company accounts for its oil and natural gas producing activities using the full cost method of accounting as prescribed by the United States Securities and Exchange Commission (SEC). Accordingly, all costs incurred in the acquisition, exploration, and development of proved oil and natural gas properties, including

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the costs of abandoned properties, dry holes, geophysical costs, and annual lease rentals are capitalized. All general and administrative corporate costs unrelated to drilling activities are expensed as incurred. Sales or other dispositions of oil and natural gas properties are accounted for as adjustments to capitalized costs, with no gain or loss recorded unless the ratio of cost to proved reserves would significantly change. Depletion of evaluated oil and natural gas properties is computed on the units of production method based on proved reserves. The net capitalized costs of proved oil and natural gas properties are subject to a full cost ceiling limitation in which the costs are not allowed to exceed their related estimated future net revenues discounted at 10%, net of tax considerations. In accordance with Staff Accounting Bulletin Topic 12.D.3.c., the Company utilizes the prices in effect on a date subsequent to the end of a reporting period when the full cost ceiling limitation was exceeded at the end of a reporting period and subsequent pricing exceeds pricing at the end of the reporting period.

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

Property, Plant and Equipment Other than Oil and Natural Gas Properties

Other operating property and equipment are recorded at cost. Depreciation is calculated using the straight-line method over the following estimated useful lives: pipelines, 30 years; auto, leasehold improvements, furniture and equipment, 5 years; and computers, 3 years. Upon sale, retirement, or otherwise disposed of, the cost and accumulated depreciation are removed from the accounts and any gains or losses are reflected in current operations. Maintenance and repair costs are charged to operating expense as incurred. Material expenditures, which increase the life of an asset, are capitalized and depreciated over the estimated remaining useful life of the asset.

The Company reviews its property and equipment in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144). SFAS 144 requires the Company to evaluate property and equipment as an event occurs or circumstances change that would more likely than not reduce the fair value of the property and equipment below the carrying amount. If the carrying amount of property and equipment is not recoverable from its undiscounted cash flows, then the Company would recognize an impairment loss for the difference between the carrying amount and the current fair value. Further, the Company evaluates the remaining useful lives of property and equipment at each reporting period to determine whether events and circumstances warrant a revision to the remaining depreciation periods.

Revenue Recognition

Revenues from the sale of oil and natural gas are recognized when the product is delivered at a fixed or determinable price, title has transferred, collectibility is reasonably assured and evidenced by a contract. The Company follows the sales method of accounting for its oil and natural gas revenue, so it recognizes revenue on all natural gas or crude oil sold to purchasers, regardless of whether the sales are proportionate to its ownership in the property. A receivable or liability is recognized only to the extent that the Company has an imbalance on a specific property greater than the expected remaining proved reserves.

Marketing Revenue and Expense

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

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Concentrations of Credit Risk

The Company operates a substantial portion of its oil and natural gas properties. As the operator of a property, the Company makes full payments for costs associated with the property and seeks reimbursement from the other working interest owners in the property for their share of those costs. The Company's joint interest partners consist primarily of independent oil and natural gas producers. If the oil and natural gas exploration and production industry in general were adversely affected, the ability of the Company's joint interest partners to reimburse the Company could be adversely affected.

The purchasers of the Company's oil and natural gas production consist primarily of independent marketers, major oil and natural gas companies and gas pipeline companies. The Company has not experienced any significant losses from uncollectible accounts. In 2008, the Company had two individual purchasers each accounting for in excess of 10% of our total sales, collectively representing 30% of its total sales. In 2007, the Company had one individual purchaser accounting for 10% of its total sales. In 2006, the Company had no individual purchasers accounting for more than 10% of its total sales. The Company does not believe the loss of any one of its purchasers would materially affect the Company's ability to sell the oil and natural gas it produces. The Company believes other purchasers are available in the Company's areas of operations.

Risk Management Activities

The Company follows SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133), as amended. From time to time, the Company may hedge a portion of its forecasted oil and natural gas production. Derivative contracts entered into by the Company have consisted of transactions in which the Company hedges the variability of cash flow related to a forecasted transaction. The Company has elected to not designate any of its positions for hedge accounting. Accordingly, the Company records the net change in the mark-to-market valuation of these positions, as well as payments and receipts on settled contracts, in net gain (loss) on derivative contracts on the consolidated statements of operations.

During the first quarter of 2008, the Company made the decision to mitigate a portion of its interest rate risk with interest rate swaps, which reduce the exposure to market rate fluctuations by converting variable interest rates to fixed interest rates. These interest rate swaps converted a portion of the Company's Senior Credit Agreement (as defined in Note 4, *Long-term Debt*) to a fixed rate obligation, thereby reducing the exposure to market rate fluctuations. The Company elected to not designate any of its interest rate swap positions for hedge accounting. Accordingly, the Company recorded the net change in the mark-to-market valuation of these positions, as well as all payments and receipts on settled contracts, in net gain (loss) on derivatives contracts on the consolidated statements of operations. During the second quarter of 2008, the Company repaid all outstanding borrowings under its Senior Credit Agreement. As a result, the Company made the decision to settle all of its outstanding interest rate swap positions which resulted in a gain of \$1.5 million during the second quarter of 2008 which is included in net gain (loss) on derivative contracts on the consolidated statements of operations.

Income Taxes

The Company accounts for income taxes using the asset and liability method wherein deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. Deferred tax assets are reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

In July 2006, the Financial Accounting Standards Board (FASB) issued Financial Interpretation (FIN) 48, *Accounting for Uncertainty in Income Taxes - an Interpretation of FASB 109* (FIN 48). FIN 48 created a single

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model to address accounting for the uncertainty in income tax positions and prescribes a minimum recognition threshold a tax position must meet before recognition in the financial statements.

The evaluation of a tax position in accordance with FIN 48 is a two-step process. The first step is a recognition process to determine whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more likely than not recognition threshold, it is presumed that the position will be examined by the appropriate taxing authority with full knowledge of all relevant information. The second step is a measurement process whereby a tax position that meets the more likely than not recognition threshold is calculated to determine the amount of benefit/expense to recognize in the financial statements. The tax position is measured at the largest amount of benefit/expense that is more likely than not of being realized upon ultimate settlement.

The Company includes interest and penalties relating to uncertain tax positions within interest expense and other on the Company's consolidated statements of operations.

The Company adopted the provisions of FIN 48 effective January 1, 2007 which did not have a material impact on the Company's operating results, financial position or cash flows. The Company did not record a cumulative effect adjustment related to the adoption of FIN 48.

Included in the Company's consolidated balance sheet at January 1, 2007 was approximately \$2.1 million of liabilities associated with uncertain tax positions in the jurisdictions in which it conducts business offset by reductions to existing deferred tax liabilities. This amount included \$0.1 million of accrued interest and penalties. No material amounts have been identified to date that would impact the Company's effective tax rate. The Company does not anticipate material changes to liabilities related to such uncertain tax positions within the next twelve months. Refer to Note 9, *Income Taxes*, for more details.

Generally, the Company's tax years 2005 through 2008 are either currently under audit or remain open and subject to examination by federal tax authorities or the tax authorities in Arkansas, Louisiana, New Mexico, Oklahoma and Texas, which are the jurisdictions in which the Company has its principal operations. In certain of these jurisdictions, the Company operates through more than one legal entity, each of which may have different open years subject to examination. Additionally, it is important to note that years are technically open for examination until the statute of limitations in each respective jurisdiction expires.

Tax audits may be ongoing at any point in time. Tax liabilities are recorded based on estimates of additional taxes which may be due upon the conclusion of these audits. Estimates of these tax liabilities are made based upon prior experience and are updated for changes in facts and circumstances. However, due to the uncertain and complex application of tax regulations, it is possible that the ultimate resolution of audits may result in liabilities which could be materially different from these estimates.

Asset Retirement Obligation

SFAS No. 143, *Accounting for Asset Retirement Obligations* (SFAS 143) requires that the fair value of an asset retirement cost, and corresponding liability, should be recorded as part of the cost of the related long-lived asset and subsequently allocated to expense using a systematic and rational method. The Company has recorded an asset retirement obligation to reflect the Company's legal obligations related to future plugging and abandonment of its oil and natural gas wells and gas gathering systems. The Company estimated the expected cash flow associated with the obligation and discounted the amount using a credit-adjusted, risk-free interest rate. At least annually, the Company reassesses the obligation to determine whether a change in the estimated obligation is necessary. The Company evaluates whether there are indicators that suggest the estimated cash flows underlying the obligation have materially changed. Should those indicators suggest the estimated obligation may have materially changed on an interim basis (quarterly), the Company will accordingly update its

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assessment. Additional retirement obligations increase the liability associated with new oil and natural gas wells and gas gathering systems as these obligations are incurred.

Goodwill

Goodwill represents the excess of the purchase price over the estimated fair value of the assets acquired net of the fair value of liabilities assumed in an acquisition. Goodwill decreased \$0.9 million in 2008 due to the tax effects of the exercise of stock options and the sale of restricted stock in 2008 that were included in the Company's original purchase price allocations for the KCS Energy, Inc. and Mission Resources Corporation mergers. SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142) requires that intangible assets with indefinite lives, including goodwill, be evaluated on an annual basis for impairment or more frequently if an event occurs or circumstances change that could potentially result in impairment. The Company completed its annual goodwill impairment test during the third quarters of 2008, 2007 and 2006 and no goodwill impairments were deemed necessary.

The goodwill impairment test requires the allocation of goodwill and all other assets and liabilities to reporting units. If the fair value of the reporting unit is less than the book value (including goodwill), then goodwill is reduced to its implied fair value and the amount of the writedown is charged against earnings. The assumptions used by the Company in calculating its reporting unit fair value at the time of the test include the Company's market capitalization and discounted future cash flows based on estimated reserves and production, future costs and future oil and natural gas prices. Adverse changes to any of these factors could lead to an impairment of all or a portion of the Company's goodwill in future periods.

At December 31, 2008, the Company recorded a full cost ceiling impairment of approximately \$1.0 billion. The full cost ceiling calculation dictates that prices and costs in effect as of the last day of the quarter are held constant. See Note 3, *Oil and Natural Gas Properties* for more details. As a result of the full cost ceiling impairment, the Company reviewed its goodwill for impairment as of December 31, 2008. Based on that review, no goodwill impairment was deemed necessary.

Fair Value of Financial Instruments

The estimated fair values for financial instruments under FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, are determined at discrete points in time based on relevant market information. These estimates involve uncertainties and cannot be determined with precision. The estimated fair value of cash, marketable securities, accounts receivable and accounts payable approximates their carrying value due to their short-term nature. The estimated fair value of the Company's Senior Credit Agreement approximates carrying value because the facility's interest rate approximates current market rates. The following table presents the estimated fair values of the Company's fixed interest rate debt instruments as of December 31, 2008 and 2007:

Debt	December 31, 2008		December 31, 2007	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<i>(In thousands)</i>				
7 ⁷ / ₈ % \$800 million senior notes	\$ 800,000	\$ 591,040	\$ 768,725	\$ 809,083
9 ¹ / ₈ % \$775 million senior notes	768,725	595,762	768,725	809,083
7 ¹ / ₈ % \$275 million senior notes	272,375	223,348	272,375	260,799
9 ⁷ / ₈ % senior notes	254	213	254	254
	\$ 1,841,354	\$ 1,410,363	\$ 1,041,354	\$ 1,070,136

The Company accounts for its derivative activities under the provisions of SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended. This statement, as amended, establishes accounting and reporting that every derivative instrument be recorded on the balance sheet as either an asset or liability measured at fair value. See Note 7, *Derivative and Hedging Activities* for more details.

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Stock-Based Compensation

In January 2006, the Company adopted SFAS No. 123(R), *Share-Based Payment* (SFAS 123(R)). SFAS 123(R) revises SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123), and focuses on accounting for share-based payments for services provided by employee to employer. The statement requires companies to expense the fair value of employee stock options and other equity-based compensation at the grant date. The statement does not require a certain type of valuation model, and either a binomial or Black-Scholes model may be used. The Company used the modified prospective application method as detailed in SFAS 123(R).

401(k) Plan

The Company sponsors a 401(k) tax deferred savings plan, whereby the Company matches a portion of employees' contributions in cash. Participation in the plan is voluntary and all employees of the Company who are 21 years of age are eligible to participate. The Company charged to expense plan contributions of \$2.6 million in 2008 and 2007 and \$1.7 million in 2006. The Company matches employee contributions dollar-for-dollar on the first 10% of an employee's pretax earnings.

Recently Issued Accounting Pronouncements

On December 31, 2008, the SEC published the final rules and interpretations updating its oil and gas reporting requirements. Many of the revisions are updates to definitions in the existing oil and gas rules to make them consistent with the petroleum resource management system, which is a widely accepted standard for the management of petroleum resources that was developed by several industry organizations. Key revisions include changes to the pricing used to estimate reserves utilizing a 12-month average price rather than a single day spot price which eliminates the ability to utilize subsequent prices to the end of a reporting period when the full cost ceiling was exceeded and subsequent pricing exceeds pricing at the end of a reporting period, the ability to include nontraditional resources in reserves, the use of new technology for determining reserves, and permitting disclosure of probable and possible reserves. The SEC will require companies to comply with the amended disclosure requirements for registration statements filed after January 1, 2010, and for annual reports on Form 10-K for fiscal years ending on or after December 15, 2009. Early adoption is not permitted. The Company is currently assessing the impact that the adoption will have on the Company's disclosures, operating results, financial position and cash flows.

In March 2008, the FASB issued Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133* (SFAS 161). SFAS 161 requires entities that utilize derivative instruments to provide qualitative disclosures about their objectives and strategies for using such instruments, as well as any details of credit-risk-related contingent features contained within derivatives. SFAS 161 also requires entities to disclose additional information about the amounts and location of derivatives located within the financial statements, how the provisions of SFAS 133 have been applied, and the impact that hedges have on an entity's operating results, financial position or cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The Company is currently assessing the impact, if any, that the adoption of this pronouncement will have on the Company's disclosures.

In December 2007, the FASB issued SFAS No. 141, *Business Combinations* (SFAS 141R), and SFAS No. 160, *Accounting and Reporting of Noncontrolling Interest in Consolidated Financial Statements, an amendment of ARB No. 51* (SFAS 160). SFAS 141R and SFAS 160 will significantly change the accounting for and reporting of business combination transactions and noncontrolling (minority) interests in consolidated financial statements. SFAS 141R retains the fundamental requirements in Statement 141, *Business Combinations*, while providing additional definitions, such as the definition of the acquirer in a purchase and improvements in the application of how the acquisition method is applied. SFAS 160 will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests, and classified as a component of equity. These Statements become simultaneously effective January 1, 2009. Early adoption is not permitted. The

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Company is currently assessing the impact, if any, that the adoption of this pronouncement will have on the Company's operating results, financial position or cash flows.

In April 2007, the FASB issued FSP No. FIN 39-1, *Amendment of FASB Interpretation No. 39*, (FIN 39-1) to amend FIN 39, *Offsetting of Amounts Related to Certain Contracts* (FIN 39). The terms conditional contracts and exchange contracts used in FIN 39 have been replaced with the more general term derivative contracts. In addition, FIN 39-1 permits the offsetting of recognized fair values for the right to reclaim cash collateral or the obligation to return cash collateral against fair values of derivatives under certain circumstances, such as under master netting arrangements. Additional disclosure is also required regarding a Company's accounting policy with respect to offsetting fair value amounts. The Company adopted FIN 39-1 on January 1, 2008 and elected not to offset fair value amounts as part of the adoption of this FASB Interpretation. There was no impact on the Company's operating results, financial position or cash flows.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* (SFAS 159), which permits entities to choose to measure many financial instruments and certain other items at fair value (Fair Value Option). Election of the Fair Value Option is made on an instrument-by-instrument basis and is irrevocable. At the adoption date, unrealized gains and losses on financial assets and liabilities for which the Fair Value Option has been elected would be reported as a cumulative adjustment to beginning retained earnings. Following the election of the Fair Value Option for certain financial assets and liabilities, the Company would report unrealized gains and losses due to changes in fair value in earnings at each subsequent reporting date. The Company adopted SFAS 159 effective January 1, 2008 which did not have a material impact on the Company's operating results, financial position or cash flows as the Company did not elect the Fair Value Option for any of its financial assets or liabilities.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This pronouncement applies to other standards that require or permit fair value measurements. Accordingly, this statement does not require any new fair value measurements. The Company adopted the provisions of SFAS 157 on January 1, 2008. See Fair Value Measurements below for more details.

Fair Value Measurements

In September 2006, the FASB issued SFAS 157 which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The provisions of SFAS 157 are effective January 1, 2008. The FASB has also issued Staff Position (FSP) SFAS 157-2 (FSP No. 157-2), which delays the effective date of SFAS 157 for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008. Effective January 1, 2008, the Company adopted SFAS 157 as discussed above and has elected to defer the application thereof to nonfinancial assets and liabilities in accordance with FSP No. 157-2. Non-recurring nonfinancial assets and nonfinancial liabilities for which the Company has not applied the provisions of SFAS 157 include those measured at fair value in goodwill impairment testing, asset retirement obligations initially measured at fair value, and those initially measured at fair value in a business combination.

In October 2008, the FASB issued FSP SFAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (FSP No. 157-3), which clarifies the application of SFAS No. 157 in an inactive market and illustrates how an entity would determine fair value when the market for a financial asset is not active. The guidance provided by FSP No. 157-3 did not have a material impact on the Company's operating results, financial position or cash flows.

The Company utilizes derivative contracts to economically hedge against the variability in cash flows associated with the forecasted sale of its anticipated future oil and natural gas production. The Company generally economically hedges a substantial, but varying, portion of anticipated oil and natural gas production for

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the next 12-24 months. Derivatives are carried at fair value on the consolidated balance sheets, with the changes in the fair value included in the consolidated statements of operations for the period in which the change occurs.

Periodically, the Company utilizes marketable securities to invest a portion of its cash on hand. These securities are carried at fair value on the consolidated balance sheets, with the changes in the fair value included in the consolidated statements of operations for the period in which the change occurs.

As defined in SFAS 157, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). The Company utilizes market data or assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable. The Company classifies fair value balances based on the observability of those inputs. SFAS 157 establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurement) and the lowest priority to unobservable inputs (level 3 measurement).

The three levels of the fair value hierarchy defined by SFAS 157 are as follows:

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

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

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

The following table sets forth by level within the fair value hierarchy the Company's financial assets and liabilities that were accounted for at fair value as of December 31, 2008. As required by SFAS 157, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels.

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

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Derivatives listed above include collars, swaps, basis swaps and puts that are carried at fair value. The fair value amounts in current period earnings associated with the Company's derivatives resulted from Level 2 fair value methodologies; that is, the Company is able to value the assets and liabilities based on observable market data for similar instruments. This observable data includes the forward curve for commodity prices based on quoted markets prices and prospective volatility factors related to changes in the forward curves.

As of December 31, 2008, the Company's derivative contracts were placed at major financial institutions with investment grade credit ratings which are believed to have a minimal credit risk. As such, the Company is exposed to credit risk to the extent of nonperformance by the counterparties in the derivative contracts discussed above; however, the Company does not anticipate such nonperformance.

Marketable securities listed above are carried at fair value. The fair value amounts in current period earnings associated with the Company's marketable securities resulted from Level 1 fair value methodologies; that is, the Company is able to value the assets based on quoted fair values for identical instruments.

2. ACQUISITIONS AND DIVESTITURES

Acquisitions

KCS Energy, Inc.

On April 21, 2006, the Company and KCS Energy, Inc. (KCS) announced they had entered into a definitive agreement to merge the companies. This merger was consummated on July 12, 2006 and was consistent with management's goals of acquiring properties within the Company's core operating areas that have a significant proved reserve component and which management believes have additional development and exploration opportunities.

Upon the closing of the merger, KCS stockholders became entitled to receive a combination of \$9.00 cash and 1.65 shares of Petrohawk common stock for each share of KCS common stock. At the time of the merger, there were approximately 50.0 million shares of unrestricted KCS common stock outstanding that converted into approximately 82.6 million shares of unrestricted Petrohawk common stock. Total consideration for the shares of KCS common stock was comprised of approximately \$1.1 billion of Petrohawk common stock, calculated based on the five day average of Petrohawk's common stock around the merger announcement date, or \$13.44, approximately \$450 million of cash and the assumption of \$275 million of KCS debt. In addition, all outstanding options to purchase KCS common stock and restricted shares of KCS common stock were converted into options to purchase the Company's common stock or restricted shares of the Company's common stock using an exchange ratio of 2.3706 shares of Petrohawk common stock to one share of KCS common stock.

The merger was accounted for using the purchase method of accounting under the accounting standards established in SFAS No. 141, *Business Combinations* (SFAS 141) and SFAS 142. As a result, the Company reflected the results of operations of KCS beginning July 12, 2006. The Company recorded the estimated fair values of the assets acquired and liabilities assumed at July 12, 2006, which primarily consisted of oil and natural gas properties of \$1.6 billion, asset retirement obligations of \$15.1 million, a deferred income tax liability of \$421.6 million, a deferred income tax asset of \$49.1 million and goodwill of \$767.1 million. The deferred income tax liability recognizes the difference between the tax basis and the fair value of the acquired oil and natural gas properties. The recorded book value of the oil and natural gas properties was increased and goodwill was recorded to recognize this tax basis differential, none of which is deductible for tax purposes. The deferred income tax asset pertains to net operating loss carry-forwards and alternative minimum tax credits in the amounts of \$44 million, net of tax, and \$5.1 million, respectively.

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Other Transactions

Fayetteville Shale

On January 7, 2008, the Company entered into an agreement to purchase additional properties located in the Fayetteville Shale for \$231.3 million after customary closing adjustments. The transaction closed on February 8, 2008. The acquired properties include interests primarily in Van Buren and Cleburne Counties, Arkansas. These properties are substantially undeveloped. During the second half of 2007, the Company completed three separate acquisitions for total cash consideration of approximately \$409 million.

Elm Grove Field

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

One TEC, LLC

On August 3, 2007 the Company completed the acquisition of all of the membership interests of One TEC, LLC (One TEC) for approximately \$42.0 million. The One TEC acquisition was accounted for using the purchase method of accounting under the accounting standards established in SFAS 141 and SFAS 142. As a result, the Company reflected the results of operations of One TEC beginning August 3, 2007. The Company recorded the estimated fair values of the assets acquired and liabilities assumed at August 3, 2007, which primarily consisted of oil and natural gas properties of \$35.0 million.

North Louisiana Acquisitions

On January 27, 2006, the Company completed the acquisition of all of the issued and outstanding common stock of Winwell Resources, Inc. (Winwell). The aggregate consideration paid was approximately \$208 million in cash after certain closing adjustments.

The Winwell acquisition was accounted for using the purchase method of accounting under the accounting standards established in SFAS 141 and SFAS 142. As a result, the Company reflected the results of operations of Winwell beginning January 27, 2006. The Company recorded the estimated fair values of the assets acquired and liabilities assumed at January 27, 2006, which primarily consisted of oil and natural gas properties of \$219.8 million, asset retirement obligations of \$0.5 million, a net deferred tax liability of \$78.9 million, and goodwill of \$33.5 million. The deferred income tax liability recognizes the difference between the tax basis and the fair value of the acquired oil and natural gas properties. The recorded book value of the oil and natural gas properties was increased and goodwill was recorded to recognize this tax basis differential, none of which is deductible for tax purposes.

Also on January 27, 2006, the Company completed the acquisition of certain oil and natural gas assets from Redley Company (together with the Winwell acquisition, the North Louisiana Acquisitions). The aggregate consideration paid in this asset acquisition was approximately \$86.2 million, after certain closing adjustments. The Company reflected the results of operations of the acquired assets beginning January 27, 2006.

Divestitures

Gulf Coast Properties

In June 2007, the Company announced a strategic repositioning involving plans to sell its Gulf Coast properties and concentrate its efforts on developing and expanding the Company's resource-style assets, including tight-gas properties in North Louisiana and the Fayetteville Shale in central Arkansas. On November 30, 2007, the Company completed the sale of its Gulf Coast properties for \$825 million, consisting of \$700 million in cash and a \$125 million note that the purchaser could redeem at any time prior to one year from

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November 30, 2007 for \$100 million plus accrued and unpaid interest. If the redemption occurred prior to April 29, 2008, accrued interest would be waived. The economic effective date for the sale was July 1, 2007. Proceeds from the sale were recorded as a decrease to the Company's full cost pool. The note was recorded upon closing at \$100 million less a discount of \$4.8 million, or approximately \$95.2 million. On April 28, 2008, the purchaser redeemed the note for \$100 million.

In conjunction with the closing of this sale, the Company deposited \$650 million with a qualified intermediary to facilitate potential like-kind exchange transactions, all of which was utilized for property acquisitions completed during the fourth quarter of 2007 and first quarter of 2008.

In connection with the sale of the Company's Gulf Coast properties, the employment of certain employees was terminated, giving rise to termination benefits resulting in additional general and administrative expenses of \$9.5 million recorded by the Company on November 30, 2007. In addition, outstanding stock appreciation rights, stock options and restricted share awards to employees whose employment was terminated in connection with the sale were modified to extend the exercise period from 90 days to November 30, 2008, as well as to accelerate the vesting of those awards. As a result of these two modifications, the Company recognized an additional \$2.4 million of stock-based compensation expense on November 30, 2007.

Michigan, Wyoming and California

During the fourth quarter of 2006 the Company sold certain of its oil and natural gas assets in Michigan, Wyoming and California. The majority of these assets were acquired in the Company's merger with KCS. Proceeds from these three separate transactions were approximately \$135 million, before adjustments, and were recorded as a decrease to the Company's full cost pool.

Gulf of Mexico

On March 21, 2006, the Company completed the sale of substantially all of its Gulf of Mexico properties for \$43.2 million, after certain closing adjustments. These proceeds were recorded as a decrease to the Company's full cost pool.

3. OIL AND NATURAL GAS PROPERTIES

Oil and natural gas properties as of December 31, 2008 and 2007 consisted of the following:

	December 31, 2008	2007
	<i>(In thousands)</i>	
Subject to depletion	\$ 4,894,357	\$ 3,247,304
Not subject to depletion:		
Exploration wells in progress	95,744	14,818
Other capital costs:		
Incurred in 2008	1,883,950	
Incurred in 2007	296,628	376,566
Incurred in 2006	8,655	272,060
Incurred in 2005 and prior	2,991	14,121
Total not subject to depletion	2,287,968	677,565
Gross oil and gas properties	7,182,325	3,924,869
Less accumulated depletion	(2,111,038)	(769,197)
Net oil and gas properties	\$ 5,071,287	\$ 3,155,672

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The Company uses the full cost method of accounting for its investment in oil and gas properties. Under this method of accounting, all costs of acquisition, exploration and development of oil and gas reserves (including such costs as leasehold acquisition costs, geological expenditures, dry hole costs, tangible and intangible development costs and direct internal costs) are capitalized as the cost of oil and gas properties when incurred. To the extent that capitalized costs of oil and gas properties, net of accumulated depletion exceed the discounted future net revenues of proved oil and gas reserves net of deferred taxes, such excess capitalized costs would be charged to expense. Full cost companies must use the prices in effect at the end of each accounting quarter to calculate the ceiling test value of their reserves. However, subsequent commodity price increases may be utilized to calculate the ceiling value and reserves.

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

At December 31, 2008, the ceiling test value of the Company's reserves was calculated based on the December 31, 2008 West Texas Intermediate posted price of \$41.00 per barrel adjusted by lease for quality, transportation fees, and regional price differentials, and the December 31, 2008 Henry Hub spot market price of \$5.71 per million British thermal unit (MMBtu) adjusted by lease for energy content, transportation fees, and regional price differentials. Using these prices, the Company's net book value of oil and natural gas properties would have exceeded the ceiling amount by approximately \$1.0 billion before tax, \$574 million after tax, at December 31, 2008. Subsequent to year-end, the market price for Henry Hub gas and West Texas Intermediate oil did not increase. Accordingly, the Company recorded an approximate \$1.0 billion full cost ceiling impairment at December 31, 2008.

At December 31, 2007, the Company's net capitalized costs of proved oil and natural gas properties did not exceed the estimated future net revenues discounted at 10%, net of tax considerations.

Decreases in product price levels, as well as changes in production rates, levels of reserves, the evaluation of costs excluded from amortization, future development costs, and service costs and other factors could result in significant future ceiling test impairments.

4. LONG-TERM DEBT

Long-term debt as of December 31, 2008 and 2007 consisted of the following:

	December 31,	
	2008	2007
	(In thousands)	
Senior revolving credit facility	\$ 450,000	\$ 570,000
7.875% \$800 million senior notes	800,000	
9.125% \$775 million senior notes ⁽¹⁾	763,773	762,934
7.125% \$275 million senior notes ⁽²⁾	264,080	261,939
9.875% senior notes	254	254
Deferred premiums on derivatives ⁽³⁾	5,767	
	\$ 2,283,874	\$ 1,595,127

⁽¹⁾ This amount is comprised of the \$650.0 million and \$125.0 million private placements consummated in July 2006. These amounts include a \$5.9 million and \$6.9 million discount at December 31, 2008 and 2007,

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- respectively, recorded by the Company in conjunction with the issuance of the \$650.0 million notes. Additionally, these amounts include a \$1.0 million and a \$1.1 million premium at December 31, 2008 and 2007, respectively, recorded by the Company in conjunction with the issuance of the \$125.0 million notes. See 9.125% Senior Notes below for more details.*
- (2) *Amount includes a \$8.3 million and \$10.4 million discount at December 31, 2008 and 2007, respectively, recorded by the Company in conjunction with the assumption of the notes. See 7.125% Senior Notes below for more details.*
- (3) *Amount excludes \$9.4 million and \$0.8 million of deferred premiums on derivatives which have been classified as current at December 31, 2008 and 2007, respectively.*

Senior Revolving Credit Facility

The Company entered into the Third Amended and Restated Senior Revolving Credit Agreement, dated as of September 10, 2008 (the Senior Credit Agreement), between the Company, each of the lenders from time to time party thereto (the Lenders), BNP Paribas, as administrative agent for the Lenders, Bank of America, N.A. and BMO Capital Markets Financing, Inc. as co-syndication agents for the Lenders, and JPMorgan Chase Bank, N.A., Wells Fargo Bank, N.A. and Fortis Capital Corp. as co-documentation agents for the Lenders., which amends and restates its \$1 billion senior revolving credit agreement dated July 12, 2006. The Senior Credit Agreement provides for a \$1.5 billion facility with an increased borrowing base of \$1.1 billion that will be redetermined on a semi-annual basis, with the Company and the Lenders each having the right to one annual interim unscheduled redetermination, and adjusted based on the Company's oil and gas properties, reserves, other indebtedness and other relevant factors. The Company's borrowing base is subject to a reduction equal to the product of \$0.25 multiplied by the stated principal amount (without regard to any initial issue discount) of any notes that the Company may issue. During the first quarter of 2009, the Company initiated a borrowing base redetermination of its Senior Credit Agreement. See Note 13, *Subsequent Events*, for more details.

Amounts outstanding under the Senior Credit Agreement will bear interest at specified margins over the London Interbank Offered Rate (LIBOR) of 1.25% to 2.00% for Eurodollar loans or at specified margins over the Alternate Base Rate (ABR) of 0.00% to 0.50% for ABR loans. Such margins will fluctuate based on the utilization of the facility. Borrowings under the Senior Credit Agreement will be secured by first priority liens on substantially all of the Company's assets, including pursuant to the terms of the Third Amended and Restated Guarantee and Collateral Agreement, all of the assets of, and equity interests in, the Company's subsidiaries. Amounts drawn down on the facility will mature on July 1, 2013.

The Senior Credit Agreement contains customary financial and other covenants, including minimum working capital levels (the ratio of current assets plus the unused commitment under the Senior Credit Agreement to current liabilities) of not less than 1.0 to 1.0 and minimum coverage of interest expenses of not less than 2.5 to 1.0. In addition, the Company is subject to covenants limiting dividends and other restricted payments, transactions with affiliates, incurrence of debt, changes of control, asset sales, and liens on properties. At December 31, 2008, the Company was in compliance with all of its debt covenants under the Senior Credit Agreement.

On January 27, 2009, the Company completed a private placement offering to eligible purchasers of an aggregate principal amount of \$600 million 10.5% senior notes due August 1, 2014. As a result of the offering, the Company's borrowing base was decreased from \$1.1 billion to \$950 million. See Note 13, *Subsequent Events*, for more details.

7.875% Senior Notes

On May 13, 2008 and June 19, 2008, the Company issued \$500 million principal amount and \$300 million principal amount, respectively, of its 7.875% senior notes due 2015 (the 2015 Notes) pursuant to an indenture (the 2015 Indenture). The 2015 Notes were issued under and are governed by an indenture dated May 13, 2008,

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between the Company, U.S. Bank Trust National Association, as trustee, and the Company's subsidiaries named therein as guarantors.

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

On or before June 1, 2011, the Company may redeem up to 35% of the aggregate principal amount of the 2015 Notes with the net cash proceeds of certain equity offerings at a redemption price of 107.875% of the principal amount plus accrued interest and unpaid interest to the redemption date provided that: at least 65% in aggregate principal amount of the 2015 Notes originally issued under the 2015 Indenture remain outstanding immediately after the redemption. In addition, at any time prior to June 1, 2012, the Company may redeem some or all of the 2015 Notes for the principal amount thereof, plus accrued and unpaid interest plus a make whole premium equal to the excess, if any of (a) the present value at such time of (i) the redemption price of such note at June 1, 2012, (ii) plus required interest payments due on the notes, computed using a discount rate based upon the yield of U.S. Treasury securities with a constant maturity most nearly equal to the period from the redemption date to June 1, 2012 plus 50 basis points, over (b) the principal amount of such note.

On or after June 1, 2012, the Company may redeem some or all of the 2015 Notes at any time or from time to time at the redemption prices (expressed as a percentage of principal amount) set forth in the following table plus accrued and unpaid interest, if any, to the applicable redemption date, if redeemed during the 12-month period beginning June 1 of the years indicated below:

Year	Percentage
2012	103.938
2013	101.969
2014	100.000

The Company may be required to offer to repurchase the 2015 Notes at a purchase price of 101% of the principal amount, plus accrued and unpaid interest, if any, to the redemption date, in the event of a change of control as defined in the 2015 Indenture. The 2015 Indenture contains covenants that, among other things, restrict or limit the ability of the Company and its subsidiaries to: borrow money; pay dividends on stock; purchase or redeem stock or subordinated indebtedness; make investments; create liens; enter into transactions with affiliates; sell assets; and merge with or into other companies or transfer all or substantially all of the Company's assets. At December 31, 2008, the Company was in compliance with all of its debt covenants relating to the 2015 Notes.

9.125% Senior Notes

On July 12, 2006, the Company consummated its private placement of 9.125% Senior Notes, also referred to as the 2013 Notes, pursuant to an Indenture dated as of July 12, 2006 (2013 Indenture) and the First Supplemental Indenture to the 2013 Notes (the 2013 First Supplemental Indenture), among the Company, the Company's subsidiaries named therein as guarantors, and U.S. Bank National Association, as trustee. The 2013 Notes were issued at 98.735% of the face amount for gross proceeds of approximately \$642.0 million, before estimated offering expenses and the initial purchasers' discount. The Company applied a portion of the net proceeds from the sale of the 2013 Notes to fund the cash consideration paid by the Company to the KCS stockholders in connection with the Company's merger with KCS and the Company's repurchase of the 2011 Notes pursuant to a tender offer the Company concluded in July 2006.

The 2013 Notes bear interest at the rate of 9.125% per annum, payable semi-annually on January 15 and July 15 of each year, commencing January 15, 2007. The 2013 Notes mature on July 15, 2013. The 2013 Notes

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

On or before July 15, 2009, the Company may redeem up to 35% of the aggregate principal amount of the 2013 Notes with the net cash proceeds of certain equity offerings at a redemption price of 109.13% of the principal amount plus accrued interest and unpaid interest to the redemption date provided that: (i) at least 65% in aggregate principal amount of the 2013 Notes originally issued under the 2013 Indenture remain outstanding immediately after the redemption (excluding 2013 Notes held by the Company and its subsidiaries); and (ii) each redemption must occur within 90 days of the date of the closing of the related equity offering.

In addition, on or before July 15, 2010, the Company may redeem all or part of the 2013 Notes upon not less than 30 nor more than 60 days notice, at a redemption price equal to the sum of (i) the principal amount, plus (ii) accrued and unpaid interest, if any, to the redemption date, plus (iii) the make whole premium at the redemption date.

On or after July 15, 2010, the Company may redeem some or all of the 2013 Notes at any time. If any of the 2013 Notes are redeemed during any 12-month period beginning on July 15 of the year indicated below, the Company must pay the following redemption prices (expressed as percentages of principal amount) plus accrued and unpaid interest thereon, if any, to the applicable redemption date:

Year	Percentage
2010	104.563
2011	102.281
2012	100.000

The Company may be required to offer to repurchase the 2013 Notes at a purchase price of 101% of the principal amount, plus accrued and unpaid interest, if any, to the redemption date, in the event of a change of control as defined in the 2013 Indenture. Additionally, the Company may be required to offer to repurchase the 2013 Notes and, to the extent required by the terms thereof, all other indebtedness (as defined in the 2013 Indenture) that is pari passu with the 2013 Notes at a purchase price of 100% of the principal amount (or accreted value in the case of any such other pari passu indebtedness issued with a significant original issue discount) plus accrued and unpaid interest, if any, to the date of purchase, in the event net proceeds from assets sales are not applied as required by the 2013 Indenture.

The 2013 Indenture contains covenants that, among other things, restrict or limit the ability of the Company and its subsidiaries to: (i) borrow money; (ii) pay dividends on stock; (iii) purchase or redeem stock or subordinated indebtedness; (iv) make investments; (v) create liens; (vi) enter into transactions with affiliates; (vii) sell assets; and (viii) merge with or into other companies or transfer all or substantially all of the Company's assets.

The Company issued the 2013 Notes in two tranches, \$650 million on July 12, 2006 and \$125 million on July 27, 2006. The additional \$125 million in 2013 Notes were issued pursuant to the same Indenture at 101.125% of the face amount. The Company applied the net proceeds from the sale of the additional 2013 Notes to repay indebtedness outstanding under its revolving credit facility. At December 31, 2008, the Company was in compliance with all of its debt covenants relating to the 2013 Notes.

In conjunction with the issuance of the \$650 million 2013 Notes, the Company recorded a discount of \$8.2 million to be amortized over the remaining life of the notes utilizing the effective interest rate method. The

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remaining unamortized discount was \$5.9 million at December 31, 2008. In conjunction with the issuance of the \$125 million 2013 Notes, the Company recorded a premium of \$1.4 million to be amortized over the remaining life of the notes utilizing the effective interest rate method. The remaining unamortized premium was \$1.0 million at December 31, 2008.

7.125% Senior Notes

Upon effectiveness of the Company's merger with KCS, the Company assumed (pursuant to the Second Supplemental Indenture relating to the 7.125% Senior Notes, also referred to as the 2012 Notes), and subsidiaries of the Company guaranteed (pursuant to the Third Supplemental Indenture relating to such notes), all the obligations (approximately \$275 million) of KCS under the 2012 Notes and the Indenture dated April 1, 2004 (the 2012 Indenture) among KCS, U.S. Bank National Association, as trustee, and the subsidiary guarantors named therein, which governs the terms of the 2012 Notes. The 2012 Notes are guaranteed on an unsubordinated, unsecured basis by all of the Company's current subsidiaries, including the subsidiaries of KCS that the Company acquired in the merger. Interest on the 2012 Notes is payable semi-annually, on each April 1 and October 1. On or after April 1, 2008, the Company may redeem all or a portion of the 2012 Notes. If the notes are redeemed during any 12-month period beginning on April 1 of the year indicated below, the Company must pay 100% of the principal price, plus a specified premium (expressed as percentages of principal amount) plus accrued and unpaid interest thereon, if any, to the applicable redemption date:

Year	Percentage
2009	101.784
2010	100.000
2011	100.000
2012	100.000

At December 31, 2008, the Company was in compliance with all of its debt covenants under the 7.125% Senior Notes.

In conjunction with the assumption of the 7.125% Senior Notes from KCS, the Company recorded a discount of \$13.6 million to be amortized over the remaining life of the notes utilizing the effective interest rate method. The remaining unamortized discount is \$8.3 million at December 31, 2008.

The 2012 Notes are jointly and severally guaranteed on a senior unsecured basis by the Company's subsidiaries. Petrohawk, the issuer of the Notes, has no material independent assets or operations apart from the assets and operations of its subsidiaries.

9.875% Senior Notes

On April 8, 2004, Mission issued \$130.0 million of its 9.875% senior notes due 2011 (the 2011 Notes). The Company assumed these notes upon the closing of the Company's merger with Mission. In conjunction with the Company's merger with KCS, the Company extinguished substantially all of its 2011 Notes for a premium of \$14.9 million plus accrued interest of \$3.5 million. There were approximately \$0.3 million of the notes which were not redeemed and are still outstanding as of December 31, 2008. In connection with the extinguishment of substantially all of the 2011 Notes, the Company requested and received from the noteholders consent to eliminate most significant debt covenants associated with the 2011 Notes.

Table of Contents**Debt Maturities**

Aggregate maturities required on long-term debt at December 31, 2008 are due in future years as follows (in thousands):

2009 ⁽¹⁾	\$ 9,426
2010	5,767
2011	254
2012	272,375
2013	1,218,725
Thereafter	800,000
Total	\$ 2,306,547

⁽¹⁾ Amount represents deferred premiums on derivatives which have been classified as current at December 31, 2008.

Debt Issuance Costs

The Company capitalizes certain direct costs associated with the issuance of long-term debt. The Company capitalized \$23.8 million of debt issue costs in connection with the Company's issuance of 2015 Notes in May and June 2008 and in connection with the Company's amended and restated Senior Credit Agreement in September 2008. At December 31, 2008, the Company had approximately \$30.5 million of debt issuance costs remaining that are being amortized over the lives of the respective debt.

5. ASSET RETIREMENT OBLIGATION

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

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The Company recorded the following activity related to the ARO liability for the years ended December 31, 2008 and 2007 (in thousands):

ARO liability at December 31, 2006	\$ 45,326
Liabilities settled and divested ⁽¹⁾	(26,444)
Additions	2,754
Acquisitions ⁽¹⁾	414
Accretion expense	1,750
ARO liability at December 31, 2007	23,800
Liabilities settled and divested ⁽¹⁾	(339)
Additions	2,780
Acquisitions ⁽¹⁾	1,157
Accretion expense	1,246
ARO liability at December 31, 2008	\$ 28,644

⁽¹⁾ Refer to Note 2 *Acquisitions and Divestitures* for more details on the Company's acquisition and disposition activities.

6. COMMITMENTS AND CONTINGENCIES

Contingencies

From time to time, the Company may be a plaintiff or defendant in a pending or threatened legal proceeding arising in the normal course of its business. All known liabilities are accrued based on the Company's best estimate of the potential loss. While the outcome and impact of currently pending legal proceedings cannot be predicted with certainty, the Company's management and legal counsel believe that the resolution of these proceedings through settlement or adverse judgment will not have a material adverse effect on the Company's consolidated operating results, financial position or cash flows.

Lease Commitments

The Company leases corporate office space in Houston, Texas and Tulsa, Oklahoma as well as a number of other field office locations. In addition, the Company also has lease commitments related to certain vehicles, machinery and equipment under long-term operating leases. Rent expense was \$4.1 million, \$3.3 million and \$2.0 million for the years ended December 31, 2008, 2007, and 2006, respectively. As of December 31, 2008, future minimum lease payments for all non-cancelable operating leases are as follows (in thousands):

2009	\$ 5,125
2010	4,661
2011	4,420
2012	4,300
2013	4,342
Thereafter	5,820
Total	\$ 28,668

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As of December 31, 2008, the Company has drilling rig commitments totaling \$433.0 million as follows (in thousands):

2009	\$ 147,303
2010	131,725
2011	105,461
2012	48,546
2013	
Thereafter	
Total	\$ 433,035

The Company has various other contractual commitments pertaining to exploration, development and production activities. The Company has work related commitments for, among other things, pipeline and well equipment, obtaining and processing seismic data and natural gas transportation. As of December 31, 2008, the Company is obligated pay \$507.8 million as follows (in thousands):

2009	\$ 89,033
2010	39,475
2011	38,659
2012	37,146
2013	40,441
Thereafter	263,041
Total	\$ 507,795

7. DERIVATIVE AND HEDGING ACTIVITIES

The Company enters into derivative commodity contracts to economically hedge its exposure to price fluctuations on a portion of its anticipated oil and natural gas production. It is the Company's policy to enter into derivative contracts only with counterparties that are creditworthy financial institutions deemed by management as competent and competitive market makers. Each of the counterparties to the Company's derivative contracts is a lender in the Company's Senior Credit Agreement. The Company did not post collateral under any of these contracts as they are secured under the Senior Credit Agreement.

At December 31, 2008 the Company has entered into collars, swaps, put options and basis swaps. Under a collar arrangement, the Company pays the counterparty the amount which the index price rises above the ceiling price and will receive receipts equal to the floor price when the index price falls below the floor price. Periodically, the Company may pay a fixed premium to increase the floor price above the existing market value at the time the Company enters into the arrangement. A swap requires the Company to make a payment to, or receive receipts from, the counterparty based upon the differential between a specified fixed price and a price related to those quoted on the New York Mercantile Exchange (NYMEX) for each respective period. In a put option, the Company pays a fixed premium to lock in a specified floor price. When the index price falls below the floor price, the Company receives from the counterparty receipts net of the fixed premium and pays the fixed premium when the index price rises above floor price. Under a basis swap, the Company makes a payment to or receives receipts from the counterparty based upon the differential between the index price adjusted for a fixed spread and the contract's settlement location price.

During the first quarter of 2008, the Company made the decision to mitigate a portion of its interest rate risk with interest rate swaps, which mitigate exposure to market rate fluctuations by converting variable interest rates (such as those on the Company's Senior Credit Agreement) to fixed interest rates. Under these swaps, the Company makes payments to, or receives payments from, the counterparties based upon the differential between

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a specified fixed price and a price related to the three-month LIBOR. The Company has elected to not designate any of its positions for hedge accounting. Accordingly, the Company records the net change in the mark-to-market valuation of these positions, as well as all payments and receipts on settled contracts, in net gain (loss) on derivatives contracts on the consolidated statements of operations. During the second quarter of 2008, the Company repaid all outstanding borrowings under its Senior Credit Agreement. As a result, the Company made the decision to settle all of its outstanding interest rate swap positions which resulted in a gain of approximately \$1.5 million during the second quarter of 2008. This gain is included in net gain (loss) on derivative contracts on the consolidated statements of operations.

At December 31, 2008, the Company had 69 open positions summarized in the tables below: 52 natural gas collar arrangements, two natural gas swap arrangements, one natural gas basis swap arrangement, 10 natural gas put options and four crude oil price arrangements. Derivative commodity contracts settle based on NYMEX West Texas Intermediate and Henry Hub prices which may differ from the actual price received by the Company. The Company's basis swap hedges the basis differential between NYMEX Henry Hub price and the Houston Ship Channel price. During 2008, 2007 and 2006 the Company did not elect to designate any positions as cash flow hedges for accounting purposes, and accordingly, recorded the net change in the mark-to-market valuation of these contracts, as well as all payments and receipts on settled contracts, in current earnings as a component of other income and expenses on the consolidated statements of operations.

At December 31, 2008, the Company had a \$224.5 million derivative asset, which \$201.1 million was classified as current. For the year ended December 31, 2008, the Company recorded a net derivative gain of \$156.9 million (\$230.6 million unrealized gain partially offset by a \$73.7 million loss from net cash payments on settled contracts).

At December 31, 2007, the Company had 60 open positions summarized in the tables below: 36 natural gas collar arrangements, 12 natural gas swap arrangements, two natural gas put options, seven crude oil swap arrangements and three crude oil collar arrangements.

At December 31, 2007, the Company had a \$12.4 million derivative asset, all of which was classified as current, and a \$35.1 million derivative liability, \$28.2 million of which was classified as current. For the year ended December 31, 2007 the Company recorded a net derivative loss of \$35.0 million (\$79.0 million unrealized loss partially offset by a \$44.0 million gain for net cash received on settled contracts).

At December 31, 2006, the Company had 94 open positions summarized in the tables below: 73 natural gas price collar arrangements, six natural gas price swap arrangements, two natural gas put options, two crude oil price swap arrangements and 11 crude oil collar arrangements.

For the year ended December 31, 2006, the Company recorded a net derivative gain of \$124.4 million (\$134.4 million unrealized gain partially offset by a \$10.0 million loss from cash payments on settled contracts).

Natural Gas

At December 31, 2008, the Company had the following natural gas collar positions:

Period		Volume in MMBtu's	Price / Price Range	Floors		Collars		Ceilings	
				Weighted Average Price		Weighted Average Price		Weighted Average Price	
January 2009	December 2009	75,730,000	\$ 7.00 \$10.00	\$	7.57	\$	9.60 \$16.45	\$	11.79
January 2010	December 2010	29,200,000	\$7.00	\$	7.00		\$10.00	\$	10.00

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At December 31, 2008, the Company had the following natural gas swap positions:

Period		Volume in MMbtu s	Swaps Price / Price Range	Weighted Average Price
January 2009	December 2009	1,825,000	\$ 8.43	\$ 8.43
January 2010	December 2010	1,825,000	\$ 8.22	\$ 8.22

At December 31, 2008, the Company had the following natural gas basis swap position:

Period		Volume in MMbtu s	Basis Swaps Price / Price Range	Weighted Average Price
January 2009	December 2009	3,650,000	\$ 0.33	\$ 0.33

At December 31, 2008, the Company had the following natural gas put options:

Period		Volume in MMbtu s	Puts Weighted Average Price
January 2009	December 2009	14,600,000	\$ 10.00

Crude Oil

At December 31, 2008, the Company had the following crude oil swap positions:

Period		Volume in Bbls	Swaps Price / Price Range	Weighted Average Price
January 2009	December 2009	273,750	\$ 76.85 \$77.30	\$ 77.00
January 2010	December 2010	273,750	\$ 75.15 \$75.55	\$ 75.28

8. STOCKHOLDERS EQUITY

On February 1, 2008, the Company sold an aggregate of 20.7 million shares of its common stock in an underwritten public offering. The gross proceeds from the sale were approximately \$310 million, before deducting underwriting discounts and commissions and estimated expenses of \$13 million.

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

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

In connection with the Company's merger with KCS on July 12, 2006, the Company issued 83.9 million shares of its common stock as consideration to the former stockholders of KCS.

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In connection with the North Louisiana Acquisitions, on February 1, 2006, the Company issued and sold 13.0 million shares of its common stock for \$14.50 per share, for an aggregate offering amount of \$188.5 million. The Company received \$180.4 million in net proceeds from the offering. Contemporaneously with the offering, the Company agreed to repurchase, and EnCap Investments, L.P., and certain of its affiliates, agreed to sell, 3.3 million shares for \$46.2 million, which represents a price equal to the net proceeds received for those 3.3 million shares by the Company from the offering. The common stock was offered and sold pursuant to private placement exemptions from registration provided by Rule 506 of Regulation D, under Section 4(2) of the Act, Regulation S of the Act and similar exemptions under state law. Shares of the common stock were offered and sold only to accredited investors (as defined in Rule 501(a) of the Act) and non-United States persons pursuant to the offers and sales outside the United States within the meaning of Regulation S under the Act. The placement agents received a cash payment of \$7.7 million as compensation for services provided in connection with the offering and to reimburse them for certain expenses.

For the years ended December 31, 2008, 2007 and 2006, respectively, the Company has recognized \$12.3 million, \$15.5 million and \$8.2 million, respectively, of non-cash stock compensation expense.

Incentive Plans

The Company's Incentive Plans include the Third Amended and Restated 2004 Employee Incentive Plan (2004 Employee Plan), Second Amended and Restated 2004 Non-Employee Director Incentive Plan (2004 Non-Employee Director Plan), Mission Resources Corporation 1994 Stock Incentive Plan (Mission 1994 Plan), Mission Resources Corporation 1996 Stock Incentive Plan (Mission 1996 Plan) and Mission Resources Corporation 2004 Incentive Plan (Mission 2004 Plan), KCS Energy, Inc. 2001 Employee and Directors Stock Plan (KCS 2001 Plan) and the KCS Energy, Inc. 2005 Employee and Directors Stock Plan (KCS 2005 Plan) as of December 31, 2008.

Warrants, Options and Stock Appreciation Rights

Certain of the Company's incentive plans permit awards of stock appreciation rights (SARS) and stock options. A stock appreciation right is similar to a stock option, in that it represents the right to realize the increase in market price, if any, of a fixed number of shares over the grant value of the right, which is equal to the market price of the Company's common stock on the date of grant. Stock options, when exercised, are settled through the payment of the exercise price in exchange for shares of stock underlying the option. SARS, when exercised, are settled without cash in exchange for a net of tax number of shares of common stock valued on the date of settlement. Both SARS and stock options vest one-third annually after the original grant date and have a term of ten years from the date of grant.

The weighted average grant date fair value of options granted in 2008, 2007 and 2006 was \$6.1 million, \$5.4 million and \$30.7 million, respectively. At December 31, 2008, 2007 and 2006, the unrecognized compensation expense related to non-vested stock options totaled \$3.9 million, \$3.1 million and \$5.1 million, respectively, and will be recognized on a straight line basis over the weighted average remaining vesting period of 0.9 years for 2008, and 1.8 years for 2007 and 2006, respectively. There were 11,559 options, 11,650 options and 500 options which expired in 2008, 2007 and 2006, respectively.

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The following table sets forth the warrants, options and stock appreciation rights transactions for the years ended December 31, 2008, 2007 and 2006 (in thousands, except share and per share amounts).

	Number	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value ⁽¹⁾	Weighted Average Remaining Contractual Life (Years)
Outstanding at December 31, 2005	5,698,547	\$ 6.16	\$ 40,232	5.6
KCS options assumed in merger	2,585,950	3.96		
Granted	1,877,270	11.97		
Exercised	(507,342)	6.08		
Forfeited	(428,212)	14.83		
Outstanding at December 31, 2006	9,226,213	\$ 6.34	\$ 47,607	6.0
Granted	1,494,100	11.84		
Exercised	(2,378,593)	4.90		
Forfeited	(196,072)	11.96		
Outstanding at December 31, 2007	8,145,648	\$ 7.64	\$ 78,779	4.9
Granted	1,102,800	19.02		
Exercised	(3,036,031)	7.03		
Forfeited	(71,795)	13.19		
Outstanding at December 31, 2008	6,140,622	\$ 9.92	\$ 45,390	6.3

⁽¹⁾ The intrinsic value of a stock option is the amount by which the current market value of the underlying stock exceeds the exercise price of the option. The aggregate intrinsic value of stock options exercised during the years ended December 31, 2008, 2007 and 2006 was approximately \$47.5 million, \$29.5 million and \$2.8 million, respectively.

Warrants, options and stock appreciation rights outstanding at December 31, 2008 consisted of the following:

Outstanding				Exercisable			
Range of Grant Prices Per Share		Number	Weighted Average Exercise Price per share	Weighted Average Remaining Contractual Life (Years)	Number	Weighted Average Exercise Price per share	
\$0.73	5.62	1,534,169	\$ 2.84	2.6	1,534,169	\$ 2.84	
5.72	10.22	1,567,665	8.04	6.0	1,564,665	8.04	
10.23	13.61	1,533,286	11.24	7.8	727,799	11.06	
\$13.86	47.16	1,505,502	17.73	8.7	257,286	14.26	

During the second quarter of 2004, and in connection with the recapitalization of the Company by PHAWK, LLC transaction, the Company issued PHAWK, LLC 5.0 million five-year common stock purchase warrants at a price of \$3.30 per share. The warrants are exercisable at any time and expire on May 25, 2009. On July 8, 2005, shares and warrants held by PHAWK, LLC were distributed to its members, including certain members of our management. The Company had 1.4 million and 0.7 million warrants exercised and a net 1.2 million and 0.6 million shares of company stock issued during the years ended December 31, 2008 and 2007, respectively. These exercises were included within the options and warrants transactions table above.

Table of Contents**Restricted Stock**

From time to time, the Company grants shares of restricted stock to employees of the Company. Employee shares vest over a three-year period at a rate of one-third on the annual anniversary date of the grant and the non-employee directors' shares vest six-months from the date of grant. The weighted average grant date fair value of the shares granted in 2008, 2007 and 2006 was \$11.4 million, \$10.8 million and \$18.3 million, respectively. At December 31, 2008, 2007 and 2006, the unrecognized compensation expense related to non-vested restricted stock totaled \$6.8 million, \$7.5 million and \$10.4 million, respectively, and will be recognized on a straight line basis over the weighted average remaining vesting period of 1.4 years, 1.7 years and 1.9 years, respectively.

The following table sets forth the restricted stock transactions for the years ended December 31, 2008, 2007 and 2006 (in thousands, except share and per share amounts).

	Number of Shares	Weighted Average Grant Date Fair Value Per Share	Aggregate Intrinsic Value ⁽¹⁾
Unvested outstanding shares at December 31, 2005	73,334	\$ 10.87	\$ 969
KCS shares assumed in merger	616,238	13.44	
Granted	888,888	11.72	
Vested	(116,121)	11.52	
Forfeited	(19,494)	10.72	
Unvested outstanding shares at December 31, 2006	1,442,845	\$ 12.38	\$ 16,593
Granted	867,100	12.52	
Vested	(822,597)	12.23	
Forfeited	(80,505)	12.46	
Unvested outstanding shares at December 31, 2007	1,406,843	\$ 12.75	\$ 24,352
Granted	570,549	19.90	
Vested	(730,964)	22.14	
Forfeited	(38,286)	15.05	
Unvested outstanding shares at December 31, 2008	1,208,142	\$ 15.31	\$ 20,930

⁽¹⁾ The intrinsic value of restricted stock was calculated as the closing market price on December 31, 2008, 2007 and 2006 of the underlying stock multiplied by the number of restricted shares.

Performance Shares

In conjunction with the Company's merger with KCS, the Company assumed the KCS 2005 Plan under which performance share awards had been granted. The performance awards provide for a contingent right to receive shares of common stock. The grantee earns between 0% and 200% of the target amount of performance shares upon the achievement of pre-determined objectives over a three-year performance period. The objectives relate to the Company's total stockholder return (as defined in the form of performance share agreement) as compared to the total stockholder return of a group of peer companies during the performance period.

The fair value of the awards using a monte carlo technique was \$10.89 per share. The Company will recognize compensation cost of \$1.5 million over the expected service life of the performance share awards whether or not the threshold is achieved. The Company recognized \$0.7 million, \$0.5 million and \$0.3 million in compensation cost for the years ended December 31, 2008, 2007 and 2006, respectively. During the year ended December 31, 2007, approximately 19,000 net shares of restricted stock were issued as a result of the termination of certain employees with the sale of the Company's Gulf Coast properties. At December 31, 2008, the performance period was completed. A total of 200,864 shares were issued on February 16, 2009 which was equal to 200% of the target amount.

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2004 Employee Incentive Plan

Upon stockholder approval and effective July 28, 2005, the Company's Amended and Restated 2004 Employee Incentive Plan was amended and restated to be the Second Amended and Restated 2004 Employee Incentive Plan to increase the aggregate number of shares that can be issued under the 2004 Employee Plan from 2.75 million to 4.25 million. The 2004 Plan permits the Company to grant to management and other employees shares of common stock with no restrictions, shares of common stock with restrictions, stock appreciation rights and options to purchase shares of common stock.

On July 12, 2006, the Company and its stockholders approved an amendment to the 2004 Plan Employee to increase the number of shares available for issuance thereunder from 4.25 million shares to 7.05 million shares. On July 18, 2007, the Company and its stockholders approved an amendment to the 2004 Employee Plan to increase the number of shares available for issuance thereunder from 7.05 million shares to 12.55 million shares.

At December 31, 2008, 5.7 million shares were available under the 2004 Employee Plan for future issuance.

2004 Non-Employee Director Incentive Plan

In July 2004 the Company adopted the 2004 Non-Employee Director Plan covering 0.20 million shares. The plan provides for the grant of both incentive stock options and restricted shares of the Company's stock. This plan was designed to attract and retain the services of directors. At the adoption of the plan, each non-employee director received 7,500 restricted shares of the Company's common stock and each new non-employee director would receive 7,500 shares of the Company's common stock. Additional grants of 5,000 restricted shares of the Company's common stock were issued to each non-employee director on each anniversary of his or her service. Effective August, 2006, the annual equity grant to both new and existing non-employee directors increased to 10,000 shares of restricted stock, with the vice chairman of the board of directors to receive 15,000 shares of restricted stock annually. Effective June 2008, the annual compensation awarded to new and existing non-employee directors changed to \$150,000, as well as an additional \$75,000 for the Vice Chairman. The annual compensation awards were granted in the form of restricted stock, which totaled 5,900 shares for non-employee directors and 8,900 shares for the Vice Chairman for the year-end December 31, 2008. These shares vest over a six-month period from the date of grant. Shares were issued under this plan for the years ended December 31, 2008, 2007 and 2006, were 50,200, 85,000 shares, and 72,500 shares, respectively and there had been no forfeited or cancelled shares.

On July 12, 2006, the Company and its stockholders approved an amendment to the Company's 2004 Non-Employee Director Plan to increase the number of shares available for issuance thereunder from 0.4 million to 0.6 million shares. At December 31, 2008, 0.3 million shares were available under the Plan for future issuance. At December 31, 2008, all non-employee director grants have been fully vested.

KCS and Mission Incentive Plans

Upon consummation of the Company's merger with KCS, the Company assumed the KCS 2001 Plan, as amended, the KCS 2005 Plan, as amended, and associated obligations relating to grants of restricted stock, stock options and performance shares under those plans which were granted prior to the closing of the Company's merger with KCS. At December 31, 2008, no options were available under the Plan for future issuance.

No options were issued in 2008 under the KCS 2005 Plan. In 2007, the Company granted stock appreciation rights covering 0.4 million shares of common stock to employees of the Company under the KCS 2005 Plan. The stock appreciation rights have an exercise price of \$11.64 with a weighted average price of \$11.64. These stock appreciation rights vest over a three year period at a rate of one-third on the annual anniversary date of the grant and expire ten years from the grant date.

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In conjunction with the merger with Mission on July 28, 2005, the Company assumed three incentive plans. The three plans were the Mission 1994 Plan, Mission 1996 Plan and Mission 2004 Plan. At December 31, 2008, there were no options available under these plans for future issuance. No options were issued in 2008 under the three Mission plans.

8% Cumulative Convertible Preferred Stock

On June 29, 2001 the Company completed its Private Placement Offering of 8% cumulative convertible preferred stock and common stock purchase warrants, offered as units of one preferred share and one-half of one warrant at \$9.25 per unit.

In April 2006, the Company initiated a buyback of the preferred stock for \$9.25 per unit. On June 9, 2006, the Company sent the holders of the preferred shares notice of redemption as set forth in the certificate of designation for the preferred stock. On July 10, 2006, the Company completed the redemption of the preferred stock. As of December 31, 2008, there were no remaining preferred shares outstanding. All Class A and Class B warrants associated with the preferred stock expired on June 29, 2006.

Treasury Stock

In August 2004, the Company's Board of Directors terminated the stock repurchase program. During the quarter ended September 30, 2006, the Company retired its 8,382 treasury shares.

Assumptions

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

	Years Ended December 31,		
	2008	2007	2006 ⁽¹⁾
Weighted average value per option granted during the period	\$ 5.52	\$ 3.63	\$ 6.95
Assumptions ⁽²⁾⁽³⁾⁽⁴⁾ :			
Stock price volatility	39.6%	38.0%	39.0%
Risk free rate of return	2.0%	4.4%	4.9%
Expected term	3.0 years	3.0 years	2.9 years

⁽¹⁾ Includes assumptions from valuation related to the Company's merger with KCS.

⁽²⁾ The Company's estimated future forfeiture is 5% based on the Company's historical forfeiture rate.

⁽³⁾ Calculated using the Black-Scholes fair value based method.

⁽⁴⁾ The Company does not pay dividends on its common stock.

Rights Plan

On October 14, 2008, the board of directors of the Company adopted a rights plan (Rights Plan), pursuant to which it declared and paid a dividend distribution of one preferred stock purchase right (a Right) for each outstanding share of common stock of the Company to stockholders of record on October 25, 2008. The Rights Plan is designed to enable stockholders of the Company to realize maximum value for their shares of the Company by giving the board of directors of the Company time to properly evaluate various alternatives and preserve the board of directors' bargaining power and flexibility to deal with third party inquiries.

Each Right entitles the holder to purchase from the Company under certain circumstances one one-thousandth of a share of the Company's Series A Junior Participating Preferred Stock (the Preferred Stock) at a price of \$60.00, subject to adjustment. Shares of Preferred Stock purchasable upon exercise of the Rights are

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generally entitled to dividend, voting and liquidation preferences equal to 1,000 times the corresponding rights on one share of the common stock, which is protected by customary anti-dilution provisions. Accordingly, the value of the one one-thousandth interest in a share of Preferred Stock purchasable upon exercise of each Right should approximate the value of one share of common stock. A Rights Agreement between the Company and American Stock Transfer & Trust Company, as Rights Agent, governs the Rights.

The Rights are not exercisable (and are transferable only with the common stock) until a Distribution Date occurs (or they are earlier redeemed or expire), which generally will occur on the tenth day following a public announcement that a person or group of affiliated or associated persons (Acquiring Person) has acquired beneficial ownership of 15% or more of the outstanding shares of the common stock or after the commencement or announcement of a tender offer or exchange offer which would result in any such person or group of persons acquiring beneficial ownership of 15% or more of the outstanding shares of common stock. Until a Right is exercised, the holder thereof, as such, has no rights as a stockholder of the Company, including, without limitation, the right to vote or to receive dividends. The Rights will expire on October 14, 2009, unless extended or earlier redeemed or exchanged by the Company. The Rights are redeemable by the Company, in whole, but not in part, under certain circumstances at a price of \$.001 per Right.

Subject to the Company's ability to amend the terms of the Rights Plan, redeem the Rights or exchange the Rights in connection with a transaction that the board of directors determines to be in the best interests of the stockholders of the Company, in the event that any person or group of affiliated or associated person becomes an Acquiring Person, the Rights Plan provides that each holder of a Right, other than Rights that are beneficially owned by the Acquiring Person (which will thereafter be void), will have the right to receive upon exercise a number of shares of common stock having a market value of two times the exercise price of the Right.

9. INCOME TAXES

Income tax benefit (provision) for the indicated periods is comprised of the following:

	Years Ended December 31,		
	2008	2007	2006
	(In thousands)		
Current:			
Federal	\$ 10,148	\$ (11,011)	\$ (2,069)
State	5,053	(998)	(65)
	15,201	(12,009)	(2,134)
Deferred:			
Federal	176,558	(19,300)	(66,337)
State	(46,806)	(1,829)	(4,064)
	129,752	(21,129)	(70,401)
Total benefit (provision)	\$ 144,953	\$ (33,138)	\$ (72,535)

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The actual income tax benefit (provision) differs from the expected income tax benefit (provision) as computed by applying the U.S. Federal corporate income tax rate of 35% for each period as follows:

	Years Ended December 31,		
	2008	2007	2006
	(In thousands)		
Expected tax benefit (provision)	\$ 186,551	\$ (30,112)	\$ (66,184)
State taxes, net	24,651	(1,385)	(3,818)
Change in state tax rate ⁽¹⁾	(64,796)		
Other	(1,453)	(1,641)	(2,533)
Total benefit (provision)	\$ 144,953	\$ (33,138)	\$ (72,535)

⁽¹⁾ In the fourth quarter of 2008, the Company filed its federal and state tax returns for 2007. The apportionment of the Company's income to state tax jurisdictions in which the Company files tax returns changed significantly as a result of (i) the sale of the Company's Gulf Coast properties at the end of 2007 and the reinvestment of those proceeds in 2008 in properties located in states with higher income tax rates; and (ii) the continued acquisition and development of properties located in states with higher income tax rates in 2008. Therefore, the Company now expects its temporary differences to reverse at higher tax rates than it had previously estimated. As a result the Company changed its estimate of the effective tax rate applied to its temporary differences, resulting in an increase in deferred tax liabilities and income tax expense of \$64.8 million.

The components of net deferred tax assets and (liabilities) recognized are as follows:

	December 31,	
	2008	2007
	(In thousands)	
Deferred current tax assets:		
Unrealized hedging transactions	\$	\$ 5,855
Deferred current tax assets	\$	\$ 5,855
Deferred current tax liabilities:		
Unrealized hedging transactions	\$ (77,454)	\$
Deferred current tax liabilities	\$ (77,454)	\$
Deferred noncurrent tax assets:		
Net operating loss carry-forwards	\$ 331,315	\$ 125,215
Stock-based compensation expense	8,547	9,499
Unrealized hedging transactions		2,558
Alternative minimum tax credit carryforwards	8,882	18,438
Other	6,988	1,031
Gross deferred noncurrent tax assets	355,732	156,741
Valuation allowance	(825)	(692)
Deferred noncurrent tax assets	\$ 354,907	\$ 156,049
Deferred noncurrent tax liabilities:		
Book-tax differences in property basis	\$ (806,809)	\$ (831,017)

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Unrealized hedging transactions	(9,011)	
Deferred noncurrent tax liabilities	\$ (815,820)	\$ (831,017)
Net noncurrent deferred tax liabilities	\$ (460,913)	\$ (674,968)

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FIN 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities. There was not a material impact on the company's operating results, financial position or cash flows as a result of the adoption of the provisions of FIN 48. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	Liability for Unrecognized Tax Benefits (In thousands)
Balance at January 1, 2007	\$ 2,100
Additions for tax positions of prior years	1,260
Reductions for tax positions of prior years	(274)
Balance at December 31, 2007	3,086
Additions for tax positions of prior years	1,773
Reductions for tax positions of prior years	(561)
Lapse of statute of limitations	(1,111)
Balance at December 31, 2008	\$ 3,187

Generally, the Company's tax years 2005 through 2008 remain open and subject to examination by Federal tax authorities or the tax authorities in Arkansas, Louisiana, New Mexico, Oklahoma and Texas which are the jurisdictions where Petrohawk has its principal operations. In certain jurisdictions the Company operates through more than one legal entity, each of which may have different open years subject to examination. The Internal Revenue Service completed its examination of the Federal return filed by KCS Energy Inc. for the tax year ending December 31, 2005 making no adjustments to the return filed. The Company has not been notified of any other potential examinations. No material amounts of the unrecognized tax benefits have been identified to date that would impact the Company's effective tax rate.

Petrohawk recognizes interest and penalties accrued to unrecognized benefits in interest expense and other in its statements of operations. For the year ended December 31, 2008, Petrohawk recognized no interest and penalties while recognizing \$0.1 million for the tax year ending December 31, 2007. The Company had approximately \$0.1 million, \$0.2 million and \$0.1 million for the payment of interest and penalties accrued as December 31, 2008, 2007 and 2006, respectively.

As of December 31, 2008, the Company had available, to reduce future taxable income, a U.S. federal regular net operating loss (NOL) carryforward of approximately \$927.1 million (net of excess tax benefits not recognized of \$2.8 million), which expire in the years 2018 through 2028. Utilization of NOL carryforwards is subject to annual limitations due to stock ownership changes. The tax net operating loss carryforward may be limited by other factors as well. The Company also has various state NOL carryforwards, reduced by the valuation allowance for losses that the Company anticipates will expire before they can be utilized, totaling approximately \$176.4 million, (net of Texas credit for business loss carryforwards) at December 31, 2008, with varying lengths of allowable carryforward periods ranging from five to 20 years that can be used to offset future state taxable income. It is expected that these deferred tax benefits will be utilized prior to their expiration.

10. RELATED PARTY TRANSACTIONS

In February 2006, the Company repurchased approximately 3.3 million shares of its common stock held by EnCap Investments, L.P., and certain of its affiliates, at a price per share equal to the net proceeds per share that the Company received from a private offering of 13.0 million of its common shares that closed on the same day as the EnCap purchase. The 3.3 million shares were repurchased for \$46.2 million.

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11. NET (LOSS) INCOME PER COMMON SHARE

The following represents the calculation of net (loss) income per common share:

	Years Ended December 31,		
	2008	2007	2006
	(In thousands, except per share amounts)		
Basic			
Net (loss) income	\$ (388,052)	\$ 52,897	\$ 116,563
Less: preferred dividends			(217)
Net (loss) income available to common stockholders	\$ (388,052)	\$ 52,897	\$ 116,346
Weighted average basic number of shares outstanding	218,993	168,006	122,452
Basic net (loss) income per share	\$ (1.77)	\$ 0.31	\$ 0.95
Diluted			
Net (loss) income	\$ (388,052)	\$ 52,897	\$ 116,346
Plus: preferred dividends			217
Net (loss) income available to common stockholders	\$ (388,052)	\$ 52,897	\$ 116,563
Weighted average basic number of shares outstanding	218,993	168,006	122,452
Common stock equivalent shares representing shares issuable upon exercise of stock options and stock appreciation rights	Anti-dilutive	1,406	989
Common stock equivalent shares representing shares issuable upon exercise of warrants	Anti-dilutive	971	1,251
Common stock equivalent shares representing shares included upon vesting of restricted shares	Anti-dilutive	865	1,443
Weighted average diluted number of shares outstanding	218,993	171,248	126,135
Diluted net (loss) income per share	\$ (1.77)	\$ 0.31	\$ 0.92

Common stock equivalents, including stock options, SARS, restricted stock and warrants, totaling 7.3 million shares were not included in the computation of diluted net (loss) income per share because the effect would have been anti-dilutive due to the net loss for the year ended December 31, 2008. Common stock equivalents, including stock options, SARS, restricted stock and warrants, totaling 0.1 million and 0.9 million shares were not included in the computation of diluted net (loss) income per share for the years ended December 31, 2007 and 2006, respectively, because the grant prices were greater than the average market price of the common shares and the effect would have been anti-dilutive.

Table of Contents**12. ADDITIONAL FINANCIAL STATEMENT INFORMATION**

Certain balance sheet amounts are comprised of the following:

	December 31,	
	2008	2007
	(In thousands)	
Accounts receivable:		
Oil and gas sales	\$ 98,536	\$ 77,033
Gas marketing sales	36,476	
Joint interest accounts	96,485	52,210
Income taxes receivable	35,535	1,788
Advances receivable		15,906
Other	10,317	1,201
	\$ 277,349	\$ 148,138
Prepays and other:		
Prepaid insurance	\$ 2,315	\$ 2,690
Prepaid drilling costs	35,739	13,937
Other	2,009	4,392
	\$ 40,063	\$ 21,019
Accounts payable and accrued liabilities:		
Trade payables	\$ 82,028	\$ 25,751
Revenues and royalties payable	145,828	90,967
Accrued capital costs	264,888	117,748
Accrued interest expense	42,548	37,557
Prepayment liabilities	59,234	10,977
Accrued lease operating expenses	7,017	6,373
Accrued ad valorem taxes payable	4,029	5,578
Accrued employee compensation	11,723	3,468
Accrued hedging settlements		2,028
Other	22,137	31,024
	\$ 639,432	\$ 331,471

Certain cash and non-cash related items:

	Years Ended December 31,		
	2008	2007	2006
	(In thousands)		
Cash payments:			
Interest payments	\$ 144,241	\$ 128,769	\$ 43,714
Income tax payments (refunds)	22,274	(931)	4,847
Non-cash items excluded from the statements of cash flows:			
Accrued capital expenditures	147,140	6,496	87,642

13. SUBSEQUENT EVENTS

On January 27, 2009, the Company completed a private placement offering to eligible purchasers of an aggregate principal amount of \$600 million 10.5% senior notes due August 1, 2014. The notes are priced at 91.279% of the face value to yield 12.75% to maturity. Net proceeds

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from the offering were used to repay all outstanding borrowings on Petrohawk's Senior Credit Agreement, which will provide additional financial flexibility to fund a portion of its 2009 capital budget, to fund potential acquisitions, to provide for further infrastructure expansion and for general corporate purposes.

During the first quarter of 2009, the Company initiated a borrowing base redetermination of its Senior Credit Agreement. The Company's borrowing base of \$950 million, along with its existing terms and pricing, were reaffirmed.

Table of Contents**SUPPLEMENTAL OIL AND GAS INFORMATION (UNAUDITED)****Oil and Natural Gas Reserves**

Users of this information should be aware that the process of estimating quantities of proved and proved developed oil and natural gas reserves is very complex, requiring significant subjective decisions in the evaluation of all available geological, engineering and economic data for each reservoir. The data for a given reservoir 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, revisions to existing reserve estimates may occur from time to time. Although every reasonable effort is made to ensure reserve estimates reported represent the most accurate assessments possible, the subjective decisions and variances in available data for various reservoirs make these estimates generally less precise than other estimates included in the financial statement disclosures.

Proved reserves represent estimated quantities of natural gas, crude oil and condensate that geological and engineering data demonstrate, with reasonable certainty, to be recoverable in future years from known reservoirs under economic and operating conditions in effect when the estimates were made. Proved developed reserves are proved reserves expected to be recovered through wells and equipment in place and under operating methods used when the estimates were made.

Estimates of proved reserves at December 31, 2008, 2007 and 2006 were prepared by Netherland, Sewell & Associates, Inc. (Netherland, Sewell), the Company's independent consulting petroleum engineers. All proved reserves are located in the United States.

The following table illustrates the Company's estimated net proved reserves, including changes, and proved developed reserves for the periods indicated, as estimated by Netherland, Sewell. Natural gas liquids are included in natural gas reserves. Oil and natural gas liquids are based on the December 31, 2008 and 2007 West Texas Intermediate posted price of \$41.00 per barrel and \$92.50 per barrel, and posted price of \$57.75 per barrel on December 31, 2006 which are adjusted by lease for quality, transportation fees, and regional price differentials. Gas prices are based on a December 31, 2008, 2007 and 2006 Henry Hub spot market price of \$5.71 per MMBtu, \$6.80 per MMBtu and \$5.63 per MMBtu and are adjusted by lease for energy content, transportation fees, and regional price differentials. All prices are held constant in accordance with SEC guidelines.

	Proved Reserves		
	Oil (MBbls)	Gas (Mmcf)	Equivalent (Mmcfe)
Proved reserves, December 31, 2005	21,467	308,467	437,269
Extensions and discoveries	4,109	270,526	295,180
Purchase of minerals in place	8,597	485,270	536,852
Production	(2,703)	(63,645)	(79,863)
Sale of minerals in place	(6,528)	(40,653)	(79,821)
Revision of previous estimates	(531)	(30,311)	(33,497)
Proved reserves, December 31, 2006	24,411	929,654	1,076,120
Extensions and discoveries ⁽¹⁾	4,912	296,816	326,288
Purchase of minerals in place	184	42,587	43,691
Production	(2,816)	(99,506)	(116,402)
Sale of minerals in place	(11,553)	(204,093)	(273,411)
Revision of previous estimates	2,601	(10,305)	5,301
Proved reserves, December 31, 2007	17,739	955,153	1,061,587
Extensions and discoveries ⁽¹⁾	1,293	456,817	464,575
Purchase of minerals in place	147	94,406	95,288
Production	(1,554)	(102,273)	(111,597)
Sale of minerals in place	(210)	(2,342)	(3,602)
Revision of previous estimates	(3,577)	(67,076)	(88,538)
Proved reserves, December 31, 2008	13,838	1,334,685	1,417,713

⁽¹⁾ *Includes infill reserves in existing proved fields of 204,787 Mmcfe and 232,065 Mmcfe at December 31, 2008 and 2007, respectively.*

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		Proved Developed Reserves	
	Oil (Mbls)	Gas (Mmcf)	Equivalent (Mmcfe)
December 31, 2006	17,944	566,024	673,688
December 31, 2007	12,142	533,902	606,754
December 31, 2008	9,099	737,368	791,962

Capitalized Costs Relating to Oil and Natural Gas Producing Activities

The following table illustrates the total amount of capitalized costs relating to oil and natural gas producing activities and the total amount of related accumulated depreciation, depletion and amortization.

	2008	December 31, 2007 (In thousands)	2006
Evaluated properties ⁽¹⁾	\$ 5,084,726	\$ 3,249,484	\$ 2,903,763
Unevaluated properties	2,287,968	677,565	537,611
	7,372,694	3,927,049	3,441,374
Accumulated depletion, depreciation and amortization ⁽¹⁾	(2,114,024)	(770,288)	(379,984)
	\$ 5,258,670	\$ 3,156,761	\$ 3,061,390

⁽¹⁾ Amounts include costs and associated accumulated depletion, depreciation and amortization for our gas gathering systems and related support equipment.

Costs Incurred in Oil and Natural Gas Property Acquisition, Exploration and Development Activities

Costs incurred in property acquisition, exploration and development activities were as follows:

	Years Ended December 31,		
	2008	2007 (In thousands)	2006
Property acquisition costs, proved	\$ 214,315	\$ 165,614	\$ 1,406,489
Property acquisition costs, unproved	1,965,429	356,348	517,695
Exploration and extension well costs	679,887	372,438	337,076
Development costs	582,575	379,749	152,335
Total costs	\$ 3,442,206	\$ 1,274,149	\$ 2,413,595

Standardized Measure of Discounted Future Net Cash Flows Relating to Proved Oil and Natural Gas Reserves

The following information has been developed utilizing SFAS 69, *Disclosures about Oil and Gas Producing Activities*, (SFAS 69) procedures and based on oil and natural gas reserve and production volumes estimated by the Company's engineering staff. It can be used for some comparisons, but should not be the only method used to evaluate the Company or its performance. Further, the information in the following table may not represent realistic assessments of future cash flows, nor should the Standardized Measure of Discounted Future Net Cash Flow be viewed as representative of the current value of the Company.

The Company believes that the following factors should be taken into account when reviewing the following information:

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future costs and selling prices will probably differ from those required to be used in these calculations;

due to future market conditions and governmental regulations, actual rates of production in future years may vary significantly from the rate of production assumed in the calculations;

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a 10% discount rate may not be reasonable as a measure of the relative risk inherent in realizing future net oil and natural gas revenues; and

future net revenues may be subject to different rates of income taxation.

Under the Standardized Measure, future cash inflows were estimated by applying year-end oil and natural gas prices to the estimated future production of year-end proved reserves. Estimates of future income taxes are computed using current statutory income tax rates including consideration for estimated future statutory depletion and tax credits. The resulting net cash flows are reduced to present value amounts by applying a 10% discount factor. Use of a 10% discount rate and year-end prices are required by SFAS 69.

The Standardized Measure is as follows:

	Years Ended December 31,		
	2008	2007	2006
	<i>(In thousands)</i>		
Future cash inflows	\$ 8,145,908	\$ 8,434,767	\$ 6,492,900
Future production costs	(1,971,585)	(2,004,206)	(1,703,787)
Future development costs	(1,631,050)	(1,227,874)	(1,044,147)
Future income tax expense	(1,058,344)	(1,549,136)	(1,004,896)
Future net cash flows before 10% discount			