PARALLEL PETROLEUM CORP
Form 10-Q
November 07, 2005

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

FORM 10-Q

(Mark One)

/X/ Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2005 or

/ / Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Transition period from to
Commission File Number 0-13305

PARALLEL PETROLEUM CORPORATION

(Exact name of registrant as specified in its charter)

DELAWARE **(State of other jurisdiction** **of incorporation or organization)**	**75-1971716** **(I.R.S. Employer Identification** **Number)**
1004 N. Big Spring, Suite 400 **Midland, Texas** **(Address of principal executive offices)**	**79701** **(Zip Code)**

(432) 684-3727

(Registrant s telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year,

if changed since last report)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes x No

At November 1, 2005, 34,140,211 shares of the Registrant s Common Stock, $0.01 par value, were outstanding.

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PART I. - FINANCIAL INFORMATION

PARALLEL PETROLEUM CORPORATION
Consolidated Balance Sheets
(dollars in thousands)

Assets	**September 30, 2005** (unaudited)	**December 31, 2004**
Current assets:		
Cash and cash equivalents	$ 6,135	$ 4,781
Accounts receivable:		
Oil and gas	14,215	6,642
Other, net of allowance for doubtful account of $9	740	389
Affiliates	10	7
	14,965	7,038
Other current assets	437	179
Deferred tax asset	6,456	2,531
Total current assets	27,993	14,529
Property and equipment, at cost:		
Oil and gas properties, full cost method (including $18,470 and $9,526 not subject to depletion)	264,178	229,245
Other	2,483	2,062
	266,661	231,307
Less accumulated depreciation, depletion and amortization	(86,941)	(78,782)
Net property and equipment	179,720	152,525
Restricted cash	149	2,287
Equity investment in Westfork Pipeline	2,209	595
Other assets, net of accumulated amortization of $792 and $581	828	735
	$ 210,899	$ 170,671
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 9,556	$ 5,568
Asset retirement obligations	133	150
Derivative obligations	18,811	7,965
Total current liabilities	28,500	13,683
Revolving credit facility	68,000	79,000
Asset retirement obligations	2,154	1,982
Derivative obligations	31,861	9,525
Deferred tax liability	4,233	6,487
Total long-term liabilities	106,248	96,994
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Series A preferred stock -- par value $0.10 per share, authorized 50,000 shares		
Preferred stock -- 6% convertible preferred stock -- par value of $0.10 per share (liquidation preference of $10 per share), authorized 10,000,000 shares, issued and outstanding 950,000, converted to common stock June, 2005		95
Common stock -- par value $0.01 per share, authorized 60,000,000 shares, issued and outstanding 34,140,211 and 25,439,292	341	254
Additional paid-in capital	76,747	48,328
Retained earnings	31,292	22,073
Accumulated other comprehensive loss	(32,229)	(10,756)
Total stockholders' equity	76,151	59,994
	$ 210,899	$ 170,671

The accompanying notes are an integral part of these Consolidated Financial Statements.

(1)

PARALLEL PETROLEUM CORPORATION
Consolidated Statements of Income
(unaudited)
(in thousands, except per share data)

	Three Months Ended September 30, 2005	2004	Nine Months Ended September 30, 2005	2004
Oil and Natural Gas Revenues:				
Oil and natural gas sales	$25,501	$10,208	$53,474	$29,066
Loss on hedging and derivatives	(5,565)	(2,463)	(12,422)	(5,403)
Total revenues	19,936	7,745	41,052	23,663
Costs and expenses:				
Lease operating expense	2,663	1,894	7,399	5,437
Production taxes	1,334	458	2,615	1,407
General and administrative	1,796	1,438	4,950	3,881
Depreciation, depletion and amortization	3,104	1,984	8,159	6,030
Total costs and expenses	8,897	5,774	23,123	16,755
Operating income	11,039	1,971	17,929	6,908
Other income (expense), net:				
Gain (loss) on ineffective portion of hedges	2,864	57	(647)	64
Interest and other income	83	10	124	168
Interest expense	(950)	(509)	(2,884)	(1,464)
Other expense	(75)	(25)	(77)	(110)
Equity in income (loss) of Westfork Pipeline	22		(72)	
Total other income (expense), net	1,944	(467)	(3,556)	(1,342)
Income before income taxes	12,983	1,504	14,373	5,566
Income tax expense, deferred	(4,396)	(457)	(4,883)	(1,934)
Net income	8,587	1,047	9,490	3,632
Cumulative preferred stock dividend		(142)	(271)	(429)
Net income available to common stockholders	$8,587	$905	$9,219	$3,203
Net income per common share:				
Basic	$0.25	$0.04	$0.29	$0.13
Diluted	$0.25	$0.04	$0.28	$0.13
Weighted average common share outstanding:				
Basic	34,033	25,382	31,585	25,284
Diluted	34,951	28,531	33,900	28,342

The accompanying notes are an integral part of these Consolidated Financial Statements.

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PARALLEL PETROLEUM CORPORATION
Consolidated Statements of Cash Flows
Nine Months Ended September 30, 2005 and 2004
(unaudited)
(dollars in thousands)

	2005	**2004**
Cash flows from operating activities:		
Net income	$9,490	$3,632
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion and amortization	8,159	6,030
Accretion of asset retirement obligation	82	73
Deferred income tax expense	4,883	1,934
(Loss) gain on ineffective portion of hedges	647	(64)
Common stock issued in lieu of cash for directors fees	99	99
Stock option expense	119	127
Equity in loss of Westfork Pipeline	72	
Changes in assets and liabilities:		
Increase in accounts receivable	(7,927)	(1,190)
Increase in other current assets	(258)	(10)
Other, net	(93)	(497)
Restricted cash	(149)	
Increase in accounts payable and accrued liabilities	3,988	1,563
Net cash provided by operating activities	19,112	11,697
Cash flows from investing activities:		
Additions to oil and gas properties	(37,888)	(41,944)
Restricted cash	2,287	
Proceeds from disposition of oil and gas properties	3,028	1,693
Additions to other property and equipment	(421)	(591)
Investment in Westfork Pipeline	(1,686)	
Net cash used in investing activities	(34,680)	(40,842)
Cash flows from financing activities:		
Net borrowings (payments) on revolving credit facility	(11,000)	15,250
Proceeds (net) from common stock issued	27,743	
Proceeds from exercise of stock options	450	523
Deferred stock offering costs		(7)
Payment of preferred stock dividend	(271)	(287)
Net cash provided by financing activities	16,922	15,479
Net increase (decrease) in cash and cash equivalents	1,354	(13,666)
Cash and cash equivalents at beginning of period	4,781	17,378
Cash and cash equivalents at end of period	$6,135	$3,712
Non-cash financing and investing activities:		
Oil and gas properties asset retirement obligations, net	$73	$232
Conversion of preferred stock	$95	$
Accrued preferred stock dividend	$	$142

Other Transactions:		
Interest paid	$2,986	$1,465

The accompany notes are an integral part of these Consolidated Financial Statements.

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PARALLEL PETROLEUM CORPORATION
Consolidated Statements of Comprehensive Income (Loss)
(unaudited)
(dollars in thousands)

	Three Months Ended September 30, 2005	2004	Nine Months Ended September 30, 2005	2004
Net income	$8,587	$1,047	$9,490	$3,632
Other comprehensive loss:				
Unrealized losses on derivatives	(15,553)	(11,934)	(45,071)	(20,059)
Reclassification adjustments for losses on derivatives included in net income	5,548	2,545	12,536	5,716
Change in fair value of derivatives	(10,005)	(9,389)	(32,535)	(14,343)
Income tax benefit	3,402	3,192	11,062	4,877
Total other comprehensive loss	(6,603)	(6,197)	(21,473)	(9,466)
Total comprehensive income (loss)	$1,984	$(5,150)	$(11,983)	$(5,834)

The accompany notes are an integral part of these Consolidated Financial Statements.

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PARALLEL PETROLEUM CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. DESCRIPTION OF BUSINESS NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Parallel Petroleum Corporation was incorporated in Texas on November 26, 1979, and reincorporated in the State of Delaware on December 18, 1984.

We are engaged in the acquisition, development and exploitation of long life oil and natural gas reserves and, to a lesser extent, the exploration for new oil and natural gas reserves. Our activities are focused in the Permian Basin of west Texas and New Mexico, Liberty County in east Texas and the onshore Gulf Coast area of south Texas. We are actively evaluating, leasing and drilling new projects located in New Mexico, the Fort Worth Basin of Texas, the Cotton Valley Reef trend of east Texas and the Uinta Basin of Utah.

The financial information included herein is unaudited, except the balance sheet as of December 31, 2004 which has been derived from our audited Consolidated Financial Statements as of December 31, 2004. However, such information includes all adjustments (consisting solely of normal recurring adjustments), which are, in the opinion of management, necessary for a fair statement of the results of operations for the interim periods. The results of operations for the interim period are not necessarily indicative of the results to be expected for an entire year.

Certain information, accounting policies and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted in this Form 10-Q Report pursuant to certain rules and regulations of the Securities and Exchange Commission. These financial statements should be read in conjunction with the audited consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2004.

Unless otherwise indicated or unless the context otherwise requires, all references in this Quarterly Report on Form 10-Q to Parallel , we , us , and our are to Parallel Petroleum Corporation and its consolidated subsidiaries, Parallel L.P. and Parallel, L.L.C.

NOTE 2. STOCKHOLDERS EQUITY

Options

In September, 2003, Parallel adopted the provisions of Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, an amendment to SFAS No. 123, whereby certain transitional alternatives are available for a voluntary change to the fair value based method of accounting for stock-based employee compensation. Parallel used the prospective method which applied prospectively the fair value recognition method to all employee and director awards granted, modified or settled after the beginning of the fiscal year in which the fair value based method of accounting for stock-based compensation was adopted. The potential impact of using the fair value method for all options, on a pro forma basis, is presented in the table that follows.

For the three months ended September 30, 2005 and 2004, Parallel recognized compensation expense of approximately $0.049 million and $0.043 million respectively and for the nine months ended September 30, 2005 and 2004, Parallel recognized compensation expense of approximately $0.119 million and $0.127 million associated with its stock option grants. For the quarter ended September 30, 2005 there were 200,000 options granted. No options were granted during the quarter ended September 30, 2004.

The following table illustrates the effect on net income and earnings per share as if the fair value based method had been applied to all outstanding and unvested awards in each period. The fair value of each grant is estimated on the date of grant using the Black-Scholes option-pricing model.

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2005	**2004**	**2005**	**2004**
	(dollars in thousands, except per share data)			
Net income, as reported	$8,587	$1,047	$9,490	$3,632
Add:				
Expense recorded in 2005 and 2004	49	43	119	127
Deduct:				
Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax effects	(35)	(48)	(106)	(143)
Pro forma net income	$8,601	$1,042	$9,503	$3,616
Earnings per share:				
Basic - as reported	$0.25	$0.04	$0.29	$0.13
Basic - pro forma	$0.25	$0.04	$0.30	$0.13
Diluted - as reported	$0.25	$0.04	$0.28	$0.13
Diluted - pro forma	$0.25	$0.04	$0.28	$0.13

Sale of Equity Securities

On February 9, 2005, we sold 5,750,000 shares of our common stock, $.01 par value per share, pursuant to a public offering at a price of $5.27 per share. Gross cash proceeds were $30.3 million, and net proceeds were approximately $27.7 million. The common shares were issued under Parallel s $100.0 million Universal Shelf Registration Statement on Form S-3 which became effective in November 2004. The proceeds were used to reduce our bank debt under our revolving credit facility described in Note 3 below.

Preferred Stock

Under terms of the Preferred Stock, all of the holders of the Preferred Stock elected to convert their shares of Preferred Stock into shares of Parallel common stock based on the conversion rate of $10.00 divided by $3.50. The holders of the Preferred Stock received approximately 2.8571 shares of common stock of Parallel for each share of Preferred Stock. Dividends on the Preferred Stock ceased to accrue, and as of June 6, 2005 the Preferred Stock is no longer outstanding.

NOTE 3. REVOLVING CREDIT FACILITY

We are a party to a Second Amended and Restated Credit Agreement, dated as of September 27, 2004 (the Credit Agreement), with Citibank Texas, N.A., BNP Paribas, Citibank, F.S.B. and Western National Bank, as amended on December 27, 2004, April 1, 2005 and October 13, 2005. The Credit Agreement provides for a revolving credit facility which means that we can borrow, repay and reborrow funds drawn under the credit facility. The total amount that we can borrow and have outstanding at any one time is limited to the lesser of $200.0 million or the "borrowing base" established by our lenders. Our current borrowing base is $100.0 million. The principal amount outstanding under the credit facility at September 30, 2005 was $68.0 million, excluding $0.49 million reserved for our letters of credit. The amount of the borrowing base is based primarily upon the estimated value of our oil and gas reserves. The borrowing base amount is redetermined by the lenders semi-annually on or about April 1 and October 1 of each year or at other times required by the lenders or at our request. If, as a result of the lenders' redetermination of the borrowing base, the outstanding principal amount of our loan exceeds the borrowing base, we

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must either provide additional collateral to the lenders or repay the principal of the note in an amount equal to the excess. Except for the principal payments that may be required because of our outstanding loans being in excess of the borrowing base, interest only is payable monthly.

Loans made to us under this credit facility bear interest at Citibank s base rate or the LIBOR rate, at our election. Generally, Citibank s base rate is equal to the prime rate published in the Wall Street Journal. At September 30, 2005, Parallel had $2.0 million in base rate loans outstanding under the credit facility.

The LIBOR rate is generally equal to the sum of (a) the rate designated as "British Bankers Association Interest Settlement Rates" and offered on one, two, three, six or twelve month interest periods for deposits of $1.0 million, and (b) a margin ranging from 2.00% to 2.50%, depending upon the outstanding principal amount of the loans. If the principal amount outstanding is equal to or greater than 75% of the borrowing base, the margin is 2.50%. If the principal amount outstanding is equal to or greater than 50%, but less than 75% of the borrowing base, the margin is 2.25%. If the principal amount outstanding is less than 50% of the borrowing base, the margin is 2.00%.

The interest rate we are required to pay on our borrowings, including the applicable margin, may never be less than 4.50%. At September 30, 2005, our Libor interest rate, plus margin, was 6.57% on $31.0 million and 6.27% on $35.0 million.

In the case of base rate loans, interest is payable on the last day of each month. In the case of LIBOR loans, interest is payable on the last day of each applicable interest period.

If the total outstanding borrowings under the credit facility are less than the borrowing base, an unused commitment fee is required to be paid to the lenders. The amount of the fee is .25% of the daily average of the unadvanced amount of the borrowing base. The fee is payable quarterly.

If the borrowing base is increased, we are required to pay a fee of .375% on the amount of any increase in the borrowing base.

Parallel, L.L.C., a subsidiary of Parallel Petroleum Corporation, guaranteed payment of the loans.

Parallel s obligations to the lenders are secured by substantially all of its oil and gas properties.

All outstanding principal under the revolving credit facility is due and payable on October 31, 2010. The maturity date of our outstanding loans may be accelerated by the lenders upon the occurrence of an event of default under the Credit Agreement.

The Credit Agreement contains various restrictive covenants and compliance requirements as follows:

- at the end of each quarter, a current ratio (as defined in the credit agreement) of at least 1.1 to 1.0;
- for each period (as calculated in the Credit Agreement) ending on December 31, March 31, June 30 and September 30, a funded debt ratio (as defined in the Credit Agreement) of not more than 3.70, 3.60 and 3.50, respectively, for December 31, 2005, 2006 and 2007; and
- at all times, adjusted consolidated net worth (as defined in the Credit Agreement) of at least (a) $50.0 million, plus (b) seventy-five percent (75%) of the net proceeds from any equity securities issued by Parallel, plus (c) fifty percent (50%) of consolidated net income for each fiscal quarter, if positive, and zero percent (0%) if negative.

As of September 30, 2005 we were in compliance with all covenants.

The Credit Agreement also contains restrictions on all retained earnings and net income for payment of dividends on common stock.

If we have borrowing capacity under our Credit Agreement, we intend to borrow, repay and reborrow under the revolving credit facility from time to time as necessary, subject to borrowing base limitations, to fund:

- interpretation and processing seismic survey data;
- lease acquisitions and drilling activities;

acquisitions of producing properties or companies owning producing properties; and,

general corporate purposes.

Interest expense for the nine months ending September 30, 2005 was approximately $2.9 million not including approximately $0.102 million for interest capitalized associated with drilling projects.

NOTE 4. ACQUISITIONS

In September and October 2004, with two separate transactions, we purchased additional non-operated working interest in the Fullerton Field properties. The net purchase price for these transactions was approximately $20.9 million.

In October and December 2004, we purchased properties in the Carm-Ann San Andres and North Means Queen Unit located in Andrews and Gaines counties, Texas. The combined net purchase price was approximately $16.5 million. In the first quarter of 2005, we acquired additional interest in these properties for a net purchase price of approximately $2.3 million.

The unaudited pro forma results summarized below reflects our consolidated pro forma results of operations for the three and nine months ended September 30, 2004, assuming these acquisitions were consummated on January 1, 2004.

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2005	Pro Forma 2004	2005	Pro Forma 2004
	(in thousands, except per share data)			
Oil and gas revenue, net of hedge losses	$19,936	$9,753	$41,052	$29,851
Operating income	$11,039	$3,012	$17,929	$9,363
Net income available to common shareholders	$8,587	$1,311	$9,219	$3,960
Net income per common share:				
Basic	$0.25	$0.05	$.29	$0.16
Diluted	$0.25	$0.05	$.28	$0.15

NOTE 5. FULL COST CEILING TEST

We use the full cost method to account for our oil and gas producing activities. Under the full cost method of accounting, the net book value of oil and gas properties, less related deferred income taxes and asset retirement obligations, may not exceed a calculated ceiling . The ceiling limitation is the discounted estimated after-tax future net cash flows from proved oil and gas properties. In calculating future net cash flows, current prices and costs are generally held constant indefinitely as adjusted for qualifying cash flow hedges. The net book value of oil and gas properties, less related deferred income taxes over the ceiling, is compared to the ceiling on a quarterly and annual basis. Any excess of the net book value, less related deferred income taxes, is generally written off as an expense. Under rules and regulations of the SEC, the excess above the ceiling is not written off if, subsequent to the end of the quarter or year but prior to the release of the financial results, prices have increased sufficiently that such excess above the ceiling would not have existed if the increased prices were used in the calculations.

At September 30, 2005, we had a cushion (i.e. the excess of the ceiling over our capitalized cost) of $275.7 million. As a result, we were not required to record a reduction of our oil and gas properties under the full cost method of accounting at that time.

Under the full cost method of accounting, all costs incurred in the acquisition, exploration and development of oil and natural gas properties, including a portion of our overhead, are capitalized. In the nine month periods

ended September 30, 2005 and 2004, overhead costs capitalized were approximately $0.923 million and $0.779 million respectively.

NOTE 6. DERIVATIVE INSTRUMENTS

General

We enter into derivative contracts to provide a measure of stability in our oil and gas revenues and interest rate payments and to manage exposure to commodity price and interest rate risk. Our objective is to lock in a range of oil and gas prices and fixed interest rate. Our line of credit agreement as of September 30, 2005, required at least 50%, on a barrel of oil equivalent basis, of our estimated monthly crude oil and natural gas produced from proved producing oil and gas properties during a rolling 24 month period to be hedged. We designate our interest rate swaps, collars, puts and commodity swaps as cash flow hedges. The effective portion of the unrealized gain or loss on cash flow hedges is recorded in other comprehensive income (loss) until the forecasted transaction occurs. During the term of a cash flow hedge, the effective portion of the quarterly change in the fair value of the derivatives is recorded in stockholders equity as other comprehensive loss and then transferred to oil and gas revenues when the production is sold and interest expense as the interest accrues. Ineffective portions of hedges (changes in realized prices that do not match the changes in the hedge price) are recognized in other expense as they occur. While the hedge contract is open, the ineffective gain or loss may increase or decrease until settlement of the contract.

As of September 30, 2005, we have recorded unrealized losses of $48.8 million ($32.2 million, net of tax) related to our derivative instruments, which represented the estimated aggregate fair values of our open derivative contracts, as of that date. These unrealized losses are presented on the Consolidated Balance Sheet as a current liability of $18.8 million and long-term liabilities of $31.9 million. During the twelve month period ending September 30, 2006, we expect approximately $12.5 million, net of tax, to be transferred out of other comprehensive loss and charged to earnings.

We are exposed to credit risk in the event of nonperformance by the counterparty to these contracts, BNP Paribas. However, we periodically assess the creditworthiness of the counterparty to mitigate this credit risk.

Interest Rate Sensitivity

We entered into fixed rate swap contracts with BNP Paribas based on the 90-day LIBOR rates at the time of the contract. The effect of the swap is that we converted our variable rate debt into fixed rate debt. We will receive variable interest rates (see Note 3) and pay fixed rates as shown in the table below.

Period of Time	**Notional Amounts**	**Fixed Interest Rates**
	($ in millions)	
October 1, 2005 thru December 31, 2005	$50	3.36%
January 1, 2006 thru December 31, 2006	$50	3.82%
January 1, 2007 thru December 31, 2007	$50	4.30%
January 1, 2008 thru December 30, 2008	$50	4.74%

Commodity Price Sensitivity

<u>**Puts.**</u> We purchased put floors on volumes of 3,000 Mcf per day for a total of 642,000 Mcf during the seven month period from April 1, 2006 through October 31, 2006, at an average floor price of $7.17 per Mcf for a total consideration of approximately $0.230 million.

Collars. Collars are created by purchasing puts to establish a floor price and then selling a call which establishes a maximum amount we will receive for the oil or gas hedged. We have entered into several collars

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whereby we paid consideration to increase the floor of the contracts. Total consideration paid for these contracts is approximately $0.369 million.

A recap for the period of time, number of MMBtu s, number of barrels, and weighted average oil and gas prices is as follows:

Period of Time	Barrels of Oil	NyMex Oil Prices Floor	Cap	MMBtu of Natural Gas	Houston Ship Channel Gas Prices Floor	Cap
October 1, 2005 thru October 31, 2005		$	$	62,000	$ 5.00	$ 7.26
October 1, 2005 thru December 31, 2005	18,400	$36.00	$ 49.60		$	$
January 1, 2006 thru December 31, 2006	180,300	$44.11	$ 71.78		$	$
April 1, 2006 thru October 31, 2006		$	$	214,000	$ 6.00	$ 12.40
January 1, 2007 thru December 31, 2007	109,500	$50.00	$ 86.50			
April 1, 2007 thru October 31, 2007		$	$	214,000	$ 6.00	$ 11.05

Swaps. Generally, swaps are an agreement to buy or sell a specified commodity for delivery in the future, but at an agreed fixed price. Swap transactions convert a floating price into a fixed price. For any particular swap transaction, the counterparty is required to make a payment to the hedge party if the reference price for any settlement period is less than the swap price for such hedge, and the hedge party is required to make a payment to the counterparty if the reference price for any settlement period is greater than the swap price for such hedge.

We have entered into oil and gas swap contracts with BNP Paribas. A recap for the period of time, number of MMBtu s, number of barrels, and weighted average swap prices are as follows:

Period of Time	Barrels of Oil	Nymex Oil Swap Price
October 1, 2005 thru December 31, 2005	156,400	$30.16
January 1, 2006 thru December 20, 2006	448,000	$28.46
January 1, 2007 thru December 31, 2007	474,500	$34.36
January 1, 2008 thru December 31, 2008	439,200	$33.37

NOTE 7. NET INCOME PER COMMON SHARE

Basic earnings per share (EPS) exclude any dilutive effects of option, warrants and convertible securities and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share are computed similar to basic earnings per share. However, diluted earnings per share reflect the assumed conversion of all potentially dilutive securities.

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The following table provides the computation of basic and diluted earnings per share for the three and nine months ended September 30, 2005 and 2004:

	Three Months Ended		Nine Months Ended	
	September 30, 2005	2004	September 30, 2005	2004
	(dollars in thousands, except per share data)			
Basic EPS Computation:				
Numerator-				
Income	$ 8,587	$ 1,047	$ 9,490	$ 3,632
Preferred stock dividend		(142)	(271)	(429)
Income available to common stockholders	$ 8,587	$ 905	$ 9,219	$ 3,203
Denominator-				
Weighted average common shares outstanding	34,033	25,382	31,585	25,284
Basic EPS:				
Income per share	$ 0.25	$ 0.04	$ 0.29	$ 0.13
Diluted EPS Computation:				
Numerator-				
Income	$ 8,587	$ 1,047	$ 9,490	$ 3,632
Preferred stock dividend				
Income available to common stockholders	$ 8,587	$ 1,047	$ 9,490	$ 3,632
Denominator -				
Weighted average common shares outstanding	34,033	25,382	33,136	25,284
Employee stock options	774	346	640	274
Warrants	144	89	124	70
Preferred stock		2,714		2,714
Weighted average common shares for diluted earnings per share assuming conversion	34,951	28,531	33,900	28,342
Diluted EPS:				
Income	$ 0.25	$ 0.04	$ 0.28	$ 0.13

NOTE 8. ASSET RETIREMENT OBLIGATIONS

On January 1, 2003, we adopted Statement of Financial Accounting Standards No. 143, Accounting for Asset Retirement Obligations SFAS No. 143 . SFAS No. 143 requires us to recognize a liability for the present value of all obligations associated with the retirement of tangible long-lived assets and to capitalize an equal amount as a cost of the related oil and gas properties.

The following table summarizes our asset retirement obligation activity:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
	(in thousands)			
Beginning asset retirement obligation	$ 2,251	$ 1,943	$ 2,132	$ 1,701
Additions related to new properties	25	204	155	435
Deletions related to property disposals	(17)	(160)	(82)	(202)
Accretion expense	28	20	82	73
Ending asset retirement obligation	$ 2,287	$ 2,007	$ 2,287	$ 2,007

NOTE 9. RECENTLY ANNOUNCED ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123 (revised 2004) , Share-Based Payment (SFAS No. 123(R)). SFAS No. 123(R) requires an entity to recognize the grant-date fair value of stock options and other equity-based compensation issued to employees in the income statement. SFAS No. 123(R) initially was to be effective for the Company beginning July 1, 2005. On April 14, 2005, the Securities and Exchange Commission announced a delay in the implementation of SFAS No. 123(R) until the beginning of the fiscal year after June 15, 2005. The Company does not expect SFAS No. 123(R) to have a material impact on its results of operations.

NOTE 10. COMMITMENTS AND CONTINGENCIES

From time to time, we are a party to routine litigation incidental to our business. We are currently a defendant in one such lawsuit. We do not believe the ultimate outcome of this lawsuit will have a material adverse effect on our financial condition or results of operations. We are not aware of any other threatened litigation and we have not been a party to any bankruptcy, receivership, reorganization, adjustment or similar proceeding.

Effective January 1, 2005, we established a 401(k) Plan and Trust for eligible employees. Employees may not participate in the former SEP plan with the establishment of the 401(k) Plan and Trust. As of the nine months ending September 30, 2005 Parallel had made contributions to the 401(k) Plan and Trust of approximately $0.118 million.

NOTE 11. SUBSEQUENT EVENTS

Parallel announced on October 17, 2005 that it had entered into a Purchase and Sale Agreement to acquire producing and undeveloped oil and gas properties for an estimated purchase price of $44.5 million. The properties have estimated proved reserves of 6.4 million equivalent barrels of oil. Parallel expects to finance the acquisition through its existing credit facility plus an increased borrowing base associated with the properties being acquired. Several separate closings are expected to occur during the period of November 15, 2005 through January 15, 2006. The effective date of the purchase will be November 1, 2005. Parallel has hedged barrels of oil associated with the acquisition beginning in 2006 and ending in 2010 with a floor of $55.00 and a cap ranging from $71.00 to $82.50.

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

The following discussion and analysis should be read in conjunction with our Consolidated Financial Statements and the related notes.

OVERVIEW

Strategy

Our primary objective is to increase shareholder value of our common stock through increasing reserves, production, cash flow and earnings. We have shifted the balance of our investments from properties having high rates of production in early years to properties expected to produce more consistently over a longer term. We attempt to reduce our financial risks by dedicating a smaller portion of our capital to high risk projects, while reserving the majority of our available capital for exploitation and development drilling opportunities. Obtaining positions in long-lived oil and natural gas reserves are given priority over properties that might provide more cash flow in the early years of production, but which have shorter reserve lives. We also attempt to further reduce risk by emphasizing acquisition possibilities over high risk exploration projects.

Since the latter part of 2002, we have reduced our emphasis on high risk exploration efforts and focused on established geologic trends where we utilize the engineering, operational, financial and technical expertise of our entire staff. Although we anticipate participating in exploratory drilling activities in the future, reducing financial, reservoir, drilling and geological risks and diversifying our property portfolio are important criteria in the execution of our business plan. In summary, our current business plan:

- focuses on projects having less geological risk;
- emphasizes exploitation and enhancement activities;
- focuses on acquiring producing properties; and
- expands the scope of operations by diversifying our exploratory and development efforts, both in and outside of our current areas of operation.

Although the direction of our exploration and development activities has shifted from high risk exploratory activities to lower risk development opportunities, we will continue our efforts, as we have in the past, to maintain low general and administrative expenses relative to the size of our overall operations, utilize advanced technologies, serve as operator in appropriate circumstances, and reduce operating costs.

The extent to which we are able to implement and follow through with our business plan will be influenced by:

- the prices we receive for the oil and natural gas we produce;
- the results of reprocessing and reinterpreting our 3-D seismic data;
- the results of our drilling activities;
- the costs of obtaining high quality field services;
- our ability to find and consummate acquisition opportunities; and
- our ability to negotiate and enter into work to earn arrangements, joint venture or other similar agreements on terms acceptable to us.

Significant changes in the prices we receive for the oil and natural gas, or the occurrence of unanticipated events beyond our control may cause us to defer or deviate from our business plan, including the amounts we have budgeted for our activities.

Operating Performance

Our operating performance is influenced by several factors, the most significant of which are the prices we receive for our oil and natural gas and our production volumes. The world price for oil has overall influence on the prices that we receive for our oil production. The prices received for different grades of oil are based upon the world price for oil, which is then adjusted based upon the particular grade. Typically, light oil is sold at a premium, while heavy grades of crude are discounted. Natural gas prices we receive are influenced by:

- seasonal demand;
- weather;
- hurricane conditions in the Gulf of Mexico;
- availability of pipeline transportation to end users;
- proximity of our wells to major transportation pipeline infrastructures; and
- to a lesser extent, world oil prices.

Additional factors influencing our overall operating performance include:

- production expenses;
- overhead requirements; and
- costs of capital.

Our oil and natural gas exploration, development and acquisition activities require substantial and continuing capital expenditures. Historically, the sources of financing to fund our capital expenditures have included:

- cash flow from operations;
- sales of our equity securities;
- bank borrowings; and
- industry joint ventures.

For the three months ended September 30, 2005, the sale price we received for our crude oil production (excluding hedges) averaged $58.95 per barrel compared with $41.30 per barrel for the three months ended September 30, 2004. The average sales price we received for natural gas for the three months ended September 30, 2005 (excluding hedges), was $9.88 per Mcf compared with $5.24 per Mcf for the three months ended September 30, 2004. For information regarding prices received including our hedges, refer to the selected operating data table in the Results of Operations on page 16. Hedge costs for oil and natural gas was $5.6 million and $2.5 million for the three months ended September 30, 2005 and September 30, 2004 respectively. The gain associated with the ineffective portion of our hedges was $2.9 million for the third quarter ended September 30, 2005. The gain on ineffectiveness is caused by a narrowing of the differential price of West Texas Intermediate Light and current designated sales of West Texas Sour barrels. Actual gains or losses may increase or decrease until settlement of these contracts.

For the nine months ended September 30, 2005, the sale price we received for our crude oil production (excluding hedges) averaged $50.86 per barrel compared with $36.69 per barrel for the nine months ended September 30, 2004. The average sales price we received for natural gas for the nine months ended September 30, 2005 (excluding hedges), was $8.01 per Mcf compared with $5.45 per Mcf for the nine months ended September 30,

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2004. For information regarding prices received including our hedges, refer to the selected operating data table in the Results of Operations on page 16. Hedge costs for oil and natural gas was $12.4 million and $5.4 million for the nine months ended September 30, 2005 and September 30, 2004 respectively. The hedge loss associated with the ineffective portion of our hedges was $0.647 million for the nine months ended September 30, 2005. The loss on ineffectiveness is caused by a widening of the differential price of West Texas Intermediate Light and current designated sales of West Texas Sour barrels. Actual gains or losses may increase or decrease until settlement of these contracts.

Our oil and natural gas producing activities are accounted for using the full cost method of accounting. Under this accounting method, we capitalize all costs incurred in connection with the acquisition of oil and natural gas properties and the exploration for and development of oil and natural gas reserves. These costs include lease acquisition costs, geological and geophysical expenditures, costs of drilling productive and non-productive wells, and overhead expenses directly related to land and property acquisition and exploration and development activities. Proceeds from the disposition of oil and natural gas properties are accounted for as a reduction in capitalized costs, with no gain or loss recognized unless a disposition involves a material change in reserves, in which case the gain or loss is recognized.

Depletion of the capitalized costs of oil and natural gas properties, including estimated future development costs, is provided using the equivalent unit-of-production method based upon estimates of proved oil and natural gas reserves and production, which are converted to a common unit of measure based upon their relative energy content. Unproved oil and natural gas properties are not amortized, but are individually assessed for impairment. The cost of any impaired property is transferred to the balance of oil and gas properties being depleted. Depletion per BOE at September, 2005 and 2004 was $6.92 and $6.88 respectively.

Results of Operations

Our business activities are characterized by frequent, and sometimes significant, changes in our:

- reserve base;
- sources of production;
- product mix (gas versus oil volumes);
- the prices we receive for our oil and gas production;

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Year-to-year or other periodic comparisons of the results of our operations can be difficult and may not fully and accurately describe our condition. The following table shows selected operating data for each of the three and nine months ended September 30, 2005 and September 30, 2004.

	Three Months Ended		**Nine Months Ended**	
	9/30/2005	**9/30/2004**	**9/30/2005**	**9/30/2004**
	(in thousands, except per unit data)			
Production Volumes:				
Oil (Bbls)	**247**	168	**672**	495
Natural gas (Mcf)	**1,109**	619	**2,411**	1,995
BOE[1]	**432**	272	**1,074**	828
BOE per day	**4.7**	3.0	**3.9**	3.0
Sales Prices:				
Oil (per Bbl)[2]	**$58.95**	$41.30	**$50.86**	$36.69
Natural gas (per Mcf)[2]	**$9.88**	$5.24	**$8.01**	$5.45
BOE price [2]	**$59.09**	$37.56	**$49.81**	$35.10
BOE price[3]	**$46.19**	$28.49	**$38.24**	$28.58
Operating Revenues:				
Oil	**$14,550**	$6,966	**$34,168**	$18,184
Oil hedge	**(5,408)**	(2,159)	**(12,064)**	(4,805)
Natural gas	**10,951**	3,242	**19,306**	10,882
Natural gas hedge	**(157)**	(304)	**(358)**	(598)
	$19,936	$7,745	**$41,052**	$23,663
Operating Expenses:				
Lease operating expense	**$2,663**	$1,894	**$7,399**	$5,437
Production taxes	**1,334**	458	**2,615**	1,407
General and administrative:				
General and administrative	**1,174**	839	**3,120**	2,379
Public reporting	**622**	599	**1,830**	1,502
Depreciation, depletion and amortization	**3,104**	1,984	**8,159**	6,030
	$8,897	$5,774	**$23,123**	$16,755
Operating income	**$11,039**	$1,971	**$17,929**	$6,908

(1) A BOE means one barrel of oil equivalent using the ratio of six Mcf of gas to one barrel of oil.
(2) Excludes hedge transactions.
(3) Includes hedge transactions.

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RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004:

Our oil and natural gas revenues and production product mix are displayed in the following table for the three months ended September 30, 2005 and September 30, 2004.

Oil and Gas Revenues:

	Revenues[1]		**Production**	
	2005	2004	2005	2004
Oil (Bbls)	46 %	62 %	57 %	62 %
Natural gas (Mcf)	54 %	38 %	43 %	38 %
Total	100 %	100 %	100 %	100 %

(1) Includes hedge transactions

The following table outlines the detail of our operating revenues for the following periods.

	Three Months Ended September 30, 2005	**2004**	**Increase (Decrease)**	**% Increase (Decrease)**
	(in thousands except per unit data)			
Production Volumes:				
Oil (Bbls)	247	168	79	47 %
Natural gas (Mcf)	1,109	619	490	79 %
BOE	432	272	160	59 %
BOE/Day	4.7	3.0	1.7	57 %
Sales Price:				
Oil (per Bbl)[1]	$58.95	$41.30	$17.65	43 %
Natural gas (per Mcf)[1]	$9.88	$5.24	$4.64	89 %
BOE price[1]	$59.09	$37.56	$21.53	57 %
BOE price[2]	$46.19	$28.49	$17.70	62 %
Operating Revenues:				
Oil	$14,550	$6,966	$7,584	109 %
Oil hedges	(5,408)	(2,159)	3,249	150 %
Natural gas	10,951	3,242	7,709	238 %
Natural gas hedges	(157)	(304)	(147)	(48)%
Total	$19,936	$7,745	$12,191	157 %

(1) Excludes hedge transactions.
(2) Includes hedge transactions.

Oil revenues, excluding hedges, increased $7.6 million or 109% for the three months ended September 30, 2005 compared to the same period of 2004. Oil production volumes increased 47% attributable to acquisitions and re-stimulations in the Fullerton San Andres Field, acquisitions in the Carm-Ann San Andres Field/N. Means Queen

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Unit and current drilling activity on Diamond M, Fullerton and Carm-Ann. The increase in oil production increased revenue approximately $3.3 million for 2005. Wellhead average realized crude oil prices increased $17.65 per Bbl or 43% to $58.95 per Bbl for 2005 compared to 2004. The increase in oil price increased revenue approximately $4.3 million for 2005.

Natural gas revenues, excluding hedges, increased $7.7 million or 238% for the three months ended September 30, 2005 compared to the same period of 2004. Natural gas production volumes increased due to a Wilcox natural gas discovery in south Texas and our Barnett Shale gas wells. The increase in natural gas volumes increased revenue approximately $2.6 million for 2005. Average realized wellhead natural gas prices increased 89% or $4.64 per Mcf to $9.88 per Mcf. The increase in natural gas prices had a positive effect on revenues of approximately $5.1 million for the three months ending September 30, 2005.

Losses on oil hedges increased $3.2 million or 150% for 2005 compared to 2004 due to the increase in oil prices. Natural gas hedge losses were $0.3 million in 2004 compared to a loss of $0.2 million in 2005. On a BOE basis, hedges accounted for a realized loss of $12.90 per BOE in 2005 compared to $9.07 per BOE in 2004. We have hedged certain oil and natural gas volumes to try and mitigate price changes in our oil and natural gas product sales and to meet the requirements under our loan facility. BOE per day increased 1,700 BOE or 57% for 2005 compared to the same period in 2004.

With our current drilling program, we expect to maintain or increase our current production volumes in the fourth quarter of 2005.

Cost and Expenses:

	Three months ended September 30, 2005	2004	Increase (Decrease)	% Increase (Decrease)	
	(dollars in thousands)				
Lease operating expense	$2,663	$1,894	$769	41	%
Production taxes	1,334	458	876	191	%
General and administrative:					
General and administrative	1,174	839	335	40	%
Public reporting	622	599	23	4	%
Total general and administrative	1,796	1,438	358	25	%
Depreciation, depletion and amortization	3,104	1,984	1,120	56	%
Total	$8,897	$5,774	$3,123	54	%

Lease operating costs increased approximately $0.8 million, or 41%, to $2.7 million during the three months ended September 30, 2005 compared with $1.9 million for the same period of 2004. The increase in lease operating expense is primarily due to our acquisitions in the Fullerton San Andres Field and the Carm-Ann San Andres Field/N. Means Queen Unit, increased ad valorem taxes and increased utility costs on our oil properties. Lifting costs were $6.17 per BOE in 2005 compared to $6.97 per BOE in 2004. As we continue to exploit and develop our long-life Permian Basin oil properties (Fullerton, Carm-Ann and Diamond M), we expect that lifting costs will continue around the same level or decline due to increased efficiencies on oil properties and increased development of gas properties which have lower lifting costs. The lifting costs per BOE are also expected to be reduced by the development of natural gas properties in south Texas, Barnett Shale and New Mexico.

Production taxes increased 191% or $0.9 million in 2005, associated with a wellhead increase in revenues of $15.3 million. Production taxes in future periods will be a function of product mix, production volumes and product prices.

General and administrative expenses in total increased 25% or $0.4 million in 2005 compared to 2004. Included in our total general and administrative expenses is public reporting cost which increased 4% for 2005. The increase in general and administrative costs is primarily related to increased salaries and bonuses and the addition of

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new employees related to current business activities. General and administrative expenses capitalized to the full cost pool were $0.3 million for 2005 compared to $0.3 million in 2004. On a BOE basis, general and administrative costs were $2.72 per BOE in 2005 compared to $3.09 per BOE in 2004, while public reporting costs were $1.44 per BOE and $2.20 per BOE for the same period.

Depreciation, depletion and amortization expense increased 56% or $1.1 million for 2005 compared to 2004. Depletion per BOE was $7.19 for 2005 and $7.30 for 2004. The increase in expense is attributable to increased production. Depletion costs are highly correlated with production volumes and capital expenditures. Fiscal year 2005 depletion costs will increase with increased production volumes and capital expenditures.

Other income (expense):

	Three months ended September 30, 2005	2004	Increase (Decrease)	% Increase (Decrease)
	(dollars in thousands)			
Gain on ineffective portion of hedges	$ 2,864	$ 57	$ 2,807	4,925 %
Interest and other income	83	10	73	730 %
Interest expense, net	(950)	(509)	441	87 %
Other expense	(75)	(25)	50	200 %
Equity income in Westfork Pipeline	22		22	
Total	$ 1,944	$ (467)	$ 2,411	516 %

The gain associated with the ineffective portion of our hedges increased $2.8 million for 2005 compared to 2004. The actual gain or loss may increase or decrease until settlement of these contracts. Interest expense increased with the increase of debt from approximately $55.0 million at September 30, 2004 to $68.0 million at September 30, 2005 along with an increase of our loan interest rate for 2005. Capitalized interest on work in progress decreased interest expense by approximately $0.052 million. Our equity investment in the construction phase of the Westfork Pipeline Company LP resulted in a gain for the third quarter of 2005.

Income tax expense was $4.4 million in 2005 compared to an expense of $0.5 million in 2004. Income tax expense for 2005 will be dependent on our earnings and is expected to be approximately 34% of income before income taxes.

We had basic net income per share of $0.25 and $0.04 and diluted net income per share of $.25 and $0.04 for 2005 and 2004, respectively. Basic weighted average common shares outstanding increased from 25.3 million shares in 2004 to 34.0 million shares in 2005. The increase in common shares is due to the sale of 5.75 million shares of common stock in a public offering in February of 2005 and the redemption of preferred shares into approximately 2.7 million shares of common stock in June of 2005.

RESULTS OF OPERATIONS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004:

Our oil and natural gas revenues and production mix are displayed in the following table for the nine months ended September 30, 2005 and September 30, 2004.

Oil and Gas Revenues:

	Revenues[1]		Production	
	2005	2004	2005	2004
Oil (Bbls)	54 %	57 %	63 %	60 %
Natural gas (Mcf)	46 %	43 %	37 %	40 %
Total	100 %	100 %	100 %	100 %

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(1) Includes hedge transactions

The following table outlines the detail of our operating revenues for the following periods.

	Nine Months Ended September 30, 2005	2004	Increase (Decrease)	% Increase (Decrease)
	(in thousands except per unit data)			
Production Volumes:				
Oil (Bbls)	672	495	177	36 %
Natural gas (Mcf)	2,411	1,995	416	21 %
BOE	1,074	828	246	30 %
BOE/Day	3.9	3.0	0.9	30 %
Sales Price:				
Oil (per Bbl)[1]	$50.86	$36.69	$14.17	39 %
Natural gas (per Mcf)[1]	$8.01	$5.45	$2.56	47 %
BOE price[1]	$49.81	$35.10	$14.71	42 %
BOE price[2]	$38.24	$28.58	$9.66	34 %
Operating Revenues:				
Oil	$34,168	$18,184	$15,984	88 %
Oil hedges	(12,064)	$(4,805)	7,259	151 %
Natural gas	19,306	$10,882	8,424	77 %
Natural gas hedges	(358)	$(598)	(240)	(40)%
Total	$41,052	$23,663	$17,389	73 %

(1) Excludes hedge transactions.
(2) Includes hedge transactions.

Oil revenues, excluding hedges, increased $16.0 million or 88% for the nine months ended September 30, 2005 compared to the same period of 2004. Oil production volumes increased 36% attributable to acquisitions in the Fullerton and Carm-Ann fields and increased drilling activity in the Diamond M Reef, Fullerton and Carm-Ann fields. The increase in oil production increased revenue approximately $6.5 million for 2005. Wellhead average

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realized crude oil prices increased $14.17 per Bbl or 39% to $50.86 per Bbl for 2005 compared to 2004. The increase in oil price increased revenue approximately $9.5 million for 2005.

Natural gas revenues, excluding hedges, increased $8.4 million or 77% for the nine months ended September 30, 2005 compared to the same period of 2004. Natural gas production volumes increased 21% primarily due to drilling activity in the Wilcox, Barnett Shale and New Mexico areas. The increase in natural gas volumes increased revenue approximately $2.3 million for 2005. Average realized wellhead natural gas prices increased 47% or $2.56 per Mcf to $8.01 per Mcf. The increase in natural gas prices had a positive effect on revenues of approximately $6.1 million for the nine months ending September 30, 2005.

Losses on oil hedges increased $7.3 million or 151% for 2005 compared to 2004 due to the increase in oil prices. Natural gas hedge losses were $0.4 million in 2005 compared to a loss of $0.6 million in 2004. On a BOE basis, hedges accounted for a realized loss of $11.57 per BOE in 2005 compared to $6.52 per BOE in 2004. The purpose of our hedges is to provide a measure of stability in our oil and gas prices and to comply with loan requirements.

With our current drilling program we expect to maintain or increase our current production volumes in the fourth quarter of 2005.

Cost and Expenses:

	Nine months ended September 30, 2005	2004	Increase (Decrease)	% Increase (Decrease)
	(dollars in thousands)			
Lease operating expense	$ 7,399	$ 5,437	$ 1,962	36%
Production taxes	2,615	1,407	1,208	86%
General and administrative:				
General and administrative	3,120	2,379	741	31%
Public reporting	1,830	1,502	328	22%
Total general and administrative	4,950	3,881	1,069	28%
Depreciation, depletion and amortization	8,159	6,030	2,129	35%
Total	$ 23,123	$ 16,755	$ 6,368	38%

Lease operating costs increased approximately $2.0 million, or 36%, to $7.4 million during the nine months ended September 30, 2005 compared with $5.4 million for the same period of 2004. The increase in lease operating expense is primarily due to our acquisitions in the Fullerton San Andres Field and the Carm-Ann San Andres Field/N. Means Queen Unit, increased ad valorem taxes and increased utility costs on our oil properties. Lifting costs were $6.89 per BOE in 2005 compared to $6.57 per BOE in 2004. As we continue to exploit and develop our long-life Permian Basin oil properties (Fullerton, Carm-Ann and Diamond M), we expect that lifting costs will continue around the same level or decline due to increased efficiencies on oil properties and increased development of gas properties which have lower lifting costs. The lifting costs per BOE are also expected to be reduced by the development of natural gas properties in south Texas, Barnett Shale and New Mexico.

Production taxes increased 86% or $1.2 million in 2005, associated with a wellhead increase in revenues of $24.4 million. Production taxes are a function of product mix, production volumes and product prices.

General and administrative expenses in total increased 28% or $1.1 million in 2005 compared to 2004. Included in our total general and administrative expenses is public reporting cost which increased 22% or $0.3 million for 2005. The SOX 404 costs continue to be a significant portion of our public reporting costs and we expect SOX 404 costs to continue. The remainder of the increase in general and administrative costs is due to salaries and related benefits related to additional staffing, computer tech support and rent for increased building space. General and administrative expenses capitalized to the full cost pool were $0.9 million for 2005 compared to

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$0.8 million in 2004. On a BOE basis, general and administrative costs were $2.91 per BOE in 2005 compared to $2.87 per BOE in 2004, while public reporting costs were $1.70 per BOE and $1.81 per BOE for the same period.

Depreciation, depletion and amortization expense increased 35% or $2.1 million for 2005 compared to 2004. Depletion per BOE was $7.60 for 2005 and $7.28 for 2004. This increase is attributable to increased production. Depletion costs are highly correlated with production volumes and capital expenditures. Fiscal year 2005 depletion costs will increase with increased production volumes and capital expenditures.

Other income (expense):

	Nine months ended September 30, 2005	2004	Increase (Decrease)	% Increase (Decrease)
	(dollars in thousands)			
Gain (loss) on ineffective portion of hedges	$(647)	$ 64	$ (711)	(1,111)%
Interest and other income	124	168	(44)	(26)%
Interest expense, net	(2,884)	(1,464)	1,420	97 %
Other expense	(77)	(110)	(33)	(30)%
Equity loss in Westfork Pipeline Company LP	(72)		(72)	
Total	$(3,556)	$ (1,342)	$ 2,214	165 %

The loss associated with the ineffective portion of our hedges increased $0.7 million for 2005 compared to 2004. The actual gain or loss may increase or decrease until settlement of these contracts. Interest expense increased with the increase of debt from approximately $55.0 million at September 30, 2004 to $68.0 million at September 30, 2005 along with an increase of our loan interest rate for 2005. Capitalized interest on work in progress decreased interest expense by approximately $0.102 million. Our equity investment in the construction phase of the Westfork Pipeline Company LP resulted in a loss for 2005.

Income tax expense was $4.9 million in 2005 compared to an expense of $1.9 million in 2004. Income tax expense for 2005 will be dependent on our earnings and is expected to be approximately 34% of income before income taxes.

We had basic net income per share of $.29 and $.13 and diluted net income per share of $.28 and $.13 for 2005 and 2004, respectively. Basic weighted average common shares outstanding increased from approximately 25.3 million shares in 2004 to approximately 31.6 million shares in 2005. The increase in common shares is due to the sale of 5,750,000 shares of common stock in a public offering in February of 2005 and the redeemed preferred shares to common shares in June, 2005.

LIQUIDITY AND CAPITAL RESOURCES

Our capital resources consist primarily of cash flows from our oil and gas properties and bank borrowings supported by our oil and gas reserves. Our level of earnings and cash flows depends on many factors, including the prices we receive for oil and gas we produce.

Working capital decreased 160% or approximately $1.4 million as of September 30, 2005 compared with December 31, 2004. Current liabilities exceeded current assets by $0.5 million at September 30, 2005. The working capital decrease was primarily due to the increased current maturity of derivative obligations of approximately $10.8 million partially offset by an increase in cash and cash equivalents and accounts receivables.

Our net cash used in investing activities was $34.7 million for the nine months ended September 30, 2005 compared to $40.8 million for the same period in 2004. Our property expenditures were $37.9 million for the nine months ended September 30, 2005, which was partially offset by restricted cash utilized for property purchases of $2.3 million and proceeds from non-strategic property dispositions of $3.0 million. Parallel s investment in the

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Westfork Pipeline was $1.7 million for the nine months ended September 30, 2005. This includes equity invested in Westfork Pipeline Company I of $1.7 million and Westfork Pipeline Company II of $0.025 million. Included in our property basis for nine months ended September 30, 2005 and 2004 were net asset retirement costs of approximately $0.073 million and $0.232 million respectively (see Note 8 to Consolidated Financial Statements). Our property leasehold acquisition, development and enhancement activities were financed by our revolving credit facility, the utilization of cash flows provided by operations, cash on hand and proceeds from non strategic property sales and bank borrowings.

On February 9, 2005, we had gross cash proceeds of $30.3 million and net proceeds of approximately $27.7 million from the sale of common stock (see Note 2 to Consolidated Financial Statements). These proceeds and cash available were used to reduce our borrowings on the revolving line of credit by approximately $29.0 million.

Stockholders equity is $76.2 million for September 30, 2005 compared to $60.0 million at December 31, 2004, an increase of 27%. The increase is attributable to the net proceeds of approximately $27.7 received from the sale of equity securities of 5,750,000 shares of our common stock offset by the increase in accumulated comprehensive income (loss) of $21.5 million related to our derivative instruments (see Note 6 to Consolidated Financial Statements) and net income of $9.5 million.

Based on our 2006 projected oil and gas revenues and related expenses, available bank borrowings and expected cash derived from non-strategic asset divestitures, we believe that we will have sufficient capital resources to fund normal operations and capital requirements, including interest expense. We continually review and consider alternative methods of financing.

Bank Borrowings

We are a party to a Second Amended and Restated Credit Agreement, dated as of September 27, 2004 (the Credit Agreement), with Citibank Texas, N.A. BNP Paribas, Citibank, F.S.B. and Western National Bank, as amended on December 27, 2004, April 1, 2005 and October 13, 2005. The Credit Agreement provides for a revolving credit facility which means that we can borrow, repay and reborrow funds drawn under the credit facility. The total amount that we can borrow and have outstanding at any one time is limited to the lesser of $200.0 million or the "borrowing base" established by our lenders. Our current borrowing base is $100.0 million. The principal amount outstanding under the credit facility at September 30, 2005 was $68.0 million, excluding $0.49 million reserved for our letters of credit. The amount of the borrowing base is based primarily upon the estimated value of our oil and gas reserves. The borrowing base amount is redetermined by the lenders semi-annually on or about April 1 and October 1 of each year or at other times required by the lenders or at our request. If, as a result of the lenders' redetermination of the borrowing base, the outstanding principal amount of our loan exceeds the borrowing base, we must either provide additional collateral to the lenders or repay the principal of the note in an amount equal to the excess. Except for the principal payments that may be required because of our outstanding loans being in excess of the borrowing base, interest only is payable monthly.

Loans made to us under this credit facility bear interest at Citibank s base rate or the LIBOR rate, at our election. Generally, Citibank s base rate is equal to the prime rate published in the Wall Street Journal. At September 30, 2005, Parallel had $2.0 million in base rate loans outstanding under the credit facility.

The LIBOR rate is generally equal to the sum of (a) the rate designated as "British Bankers Association Interest Settlement Rates" and offered on one, two, three, six or twelve month interest periods for deposits of $1.0 million, and (b) a margin ranging from 2.00% to 2.50%, depending upon the outstanding principal amount of the loans. If the principal amount outstanding is equal to or greater than 75% of the borrowing base, the margin is 2.50%. If the principal amount outstanding is equal to or greater than 50%, but less than 75% of the borrowing base, the margin is

2.25%. If the principal amount outstanding is less than 50% of the borrowing base, the margin is 2.00%.

The interest rate we are required to pay on our borrowings, including the applicable margin, may never be less than 4.50%. At September 30, 2005, our Libor interest rate, plus margin, was 6.57% on $31.0 million and 6.27% on $35.0 million.

(23)

In the case of base rate loans, interest is payable on the last day of each month. In the case of LIBOR loans, interest is payable on the last day of each applicable interest period.

If the total outstanding borrowings under the credit facility are less than the borrowing base, an unused commitment fee is required to be paid to the lenders. The amount of the fee is .25% of the daily average of the unadvanced amount of the borrowing base. The fee is payable quarterly.

If the borrowing base is increased, we are required to pay a fee of .375% on the amount of any increase in the borrowing base.

Parallel, L.L.C., a subsidiary of Parallel Petroleum Corporation, guaranteed payment of the loans.

Parallel s obligations to the lenders are secured by substantially all of its oil and gas properties.

All outstanding principal under the revolving credit facility is due and payable on October 31, 2010. The maturity date of our outstanding loans may be accelerated by the lenders upon the occurrence of an event of default under the Credit Agreement.

The Credit Agreement contains various restrictive covenants and compliance requirements as follows:

- at the end of each quarter, a current ratio (as defined in the credit agreement) of at least 1.1 to 1.0;
- for each period (as calculated in the Credit Agreement) ending on December 31, March 31, June 30 and September 30, a funded debt ratio (as defined in the Credit Agreement) of not more than 3.70, 3.60 and 3.50, respectively, for December 31, 2005, 2006 and 2007; and
- at all times, adjusted consolidated net worth (as defined in the Credit Agreement) of at least (a) $50.0 million, plus (b) seventy-five percent (75%) of the net proceeds from any equity securities issued by Parallel, plus (c) fifty percent (50%) of consolidated net income for each fiscal quarter, if positive, and zero percent (0%) if negative.

As of September 30, 2005 we were in compliance with all covenants.

The Credit Agreement also contains restrictions on all retained earnings and net income for payment of dividends on common stock.

If we have borrowing capacity under our Credit Agreement, we intend to borrow, repay and reborrow under the revolving credit facility from time to time as necessary, subject to borrowing base limitations, to fund:

- interpretation and processing of 3-D seismic survey data;

lease acquisitions and drilling activities;

acquisitions of producing properties or companies owning producing properties; and,

general corporate purposes.

Interest expense for the nine months ending September 30, 2005 was approximately $2.9 million not including approximately $0.102 million for interest capitalized associated with drilling projects.

Sale of Equity Securities

On February 9, 2005, we sold 5,750,000 shares of our common stock, $.01 par value per share, pursuant to a public offering at a price of $5.27 per share. Gross cash proceeds were $30.3 million, and net proceeds were approximately $27.7 million. The common shares were issued under Parallel s $100.0 million Universal Shelf Registration Statement on Form S-3 which became effective in November 2004. The proceeds were used to reduce the revolving credit facility.

Preferred Stock

Under terms of the Preferred Stock, all of the holders of the Preferred Stock elected to convert their shares of Preferred Stock into shares of Parallel common stock based on the conversion rate of $10.00 divided by $3.50. The holders of the Preferred Stock will receive approximately 2.8571 shares of common stock of Parallel for each share of Preferred Stock. Dividends on the Preferred Stock ceased to accrue, and as of June 6, 2005 the Preferred Stock is no longer outstanding.

Commodity Price Risk Management Transactions

The purpose of our hedges is to provide a measure of stability in our oil and gas prices and interest rate payments and manage exposure to commodity price and interest rate risk in compliance with our bank facility. Our objective is to lock in a range of oil and gas prices and a fixed interest rate for certain notional amounts.

Under cash flow hedge accounting, the quarterly change in the fair value of the commodity derivatives is recorded in stockholders equity as other comprehensive loss and then transferred to revenue when the production is sold. Ineffective portions of cash flow hedges (changes in realized prices that do not match the changes in the hedge price) are recognized in other expense as they occur. While the cash flow hedge contract is open, the ineffective gain or loss many increase or decrease until settlement of the contract.

Under cash flow hedge accounting for interest rate swaps, the quarterly change in the fair value of the derivatives is recorded in stockholders equity as other comprehensive loss and then transferred to interest expense when the contract settles. Ineffective portions of cash flow hedges are recognized in other expense as they occur.

We are exposed to credit risk in the event of nonperformance by the counterparty in its derivative instruments. However, we periodically assess the creditworthiness of the counterparty to mitigate this credit risk.

Certain of our commodity price risk management arrangements have required us to deliver cash collateral or other assurances of performance to the counterparties in the event that our payment obligations with respect to our commodity price risk management transactions exceed certain levels.

Contractual Obligations, Commitments and Off-Balance Sheet Arrangements

We have contractual obligations and commitments that may affect our financial position. However, based on our assessment of the provisions and circumstances of our contractual obligation and commitments, we do not feel there would be an adverse effect on our consolidated results of operations, financial condition or liquidity.

The following table is a summary of significant contractual obligations as of September 30, 2005:

	Obligation Due in Period						
	Three months ending December 31,	**Year ended December 31,**					
Contractual Cash Obligations	**2005**	**2006**	**2007**	**2008**	**2009**	**After 5 years**	**Total**
	(in thousands)						
Revolving Credit Facility (secured)	$	$	$	$ 68,000	$	$	$ 68,000
Office Lease (Dinero Plaza)	39	105					144
Andrews and Snyder Field Offices[(1)]	6	23	23	14	14		80
Asset retirement obligations[(2)]	106	39	223	19	151	1,749	2,287
Derivative Obligations	6,093	18,454	13,965	12,160			50,672
Drilling contract	292	964	613				1,869
Total	$ 6,536	$ 19,585	$ 14,824	$ 80,193	$ 165	$ 1,749	$ 123,052

(1) The Snyder field office lease remains in effect until the termination of our trade agreement with a third party working interest owner in the Diamond M project. The Andrews field office lease expires in December 2007. The lease cost for these two office facilities are billed to nonaffiliated third party working interest owners under our joint operating

agreements with these third parties.

(2) Assets retirement obligations of oil and natural gas assets, excluding salvage value and accretion.

Outlook

The oil and natural gas industry is capital intensive. We make, and anticipate that we will continue to make, substantial capital expenditures in the exploration for, development and acquisition of oil and natural gas reserves. Historically, our capital expenditures have been financed primarily with:

- internally generated cash from operations;
- proceeds from bank borrowings; and
- proceeds from sales of equity securities.

The continued availability of these capital sources depends upon a number of variables, including:

- our proved reserves;
- the volumes of oil and natural gas we produce from existing wells;
- the prices at which we sell oil and gas; and
- our ability to acquire, locate and produce new reserves.

Each of these variables materially affects our borrowing capacity. We may from time to time seek additional financing in the form of:

- increased bank borrowings;
- sales of Parallel's securities;
- sales of non-core properties; or