

ARENA RESOURCES INC  
Form 10-Q  
November 03, 2006

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934

For the Quarterly Period Ended September 30, 2006

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 001-31657

**ARENA RESOURCES, INC.**

(Exact name of registrant as specified in its charter)

Nevada

(State or other jurisdiction of  
Incorporation or organization)

73-1596109

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

4920 South Lewis Street, Suite 107

Tulsa, Oklahoma 74105

(Address of principal executive offices)

(918) 747-6060

(Registrant's telephone number)

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 past 12 months, and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date:

As of October 30, 2006, the Company had outstanding 14,658,587 shares of common stock (\$0.001 par value).

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For the Quarter Ended September 30, 2006

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**Part I Financial Information**

**Item 1. Financial Statements:**

The condensed consolidated financial statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information 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 pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading.

In the opinion of the Company, all adjustments, consisting of only normal recurring adjustments, necessary to present fairly the consolidated financial position of the Company and the consolidated results of its operations and its cash flows have been made. The results of its operations and its cash flows for the three and nine months ended September 30, 2006 are not necessarily indicative of the results to be expected for the year ending December 31, 2006.

**ARENA RESOURCES, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(UNAUDITED)**

	September 30, 2006	December 31, 2005
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash	\$ 4,740,380	\$ 4,317,114
Accounts receivable	5,555,236	3,180,749
Joint interest billing receivable	2,123,377	140,561
Prepaid expenses	191,912	35,436
<b>Total Current Assets</b>	<b>12,610,905</b>	<b>7,673,860</b>
<b>Property and Equipment, Using Full Cost Accounting</b>		
Oil and gas properties subject to amortization	134,843,146	69,770,685
Equipment	58,962	26,687
Drilling rig	2,038,986	1,191,126
Office equipment	124,899	106,177
<b>Total Property and Equipment</b>	<b>137,065,993</b>	<b>71,094,675</b>
Less: Accumulated depreciation and amortization	(8,599,770)	(4,346,628)
<b>Net Property and Equipment</b>	<b>128,466,223</b>	<b>66,748,047</b>
<b>Total Assets</b>	<b>\$ 141,077,128</b>	<b>\$ 74,421,907</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 8,358,619	\$ 6,038,691
Income taxes payable	-	329,986
Accrued liabilities	318,390	221,519
<b>Total Current Liabilities</b>	<b>8,677,009</b>	<b>6,590,196</b>
<b>Long-Term Liabilities</b>		
Notes payable to related parties	400,000	400,000
Asset retirement liability	1,809,370	1,515,347
Deferred income taxes	16,046,187	7,187,609
<b>Total Long-Term Liabilities</b>	<b>18,255,557</b>	<b>9,102,956</b>
<b>Stockholders' Equity</b>		
Preferred stock - \$0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding	-	-
Common stock - \$0.001 par value; 100,000,000 shares authorized; 14,658,587 shares and 13,099,702 shares outstanding, respectively	14,659	13,100
Additional paid-in capital	81,446,224	45,331,234
Options and warrants outstanding	2,632,796	1,483,807
Deferred compensation	-	(115,545)
Retained earnings	30,050,883	12,016,159
<b>Total Stockholders' Equity</b>	<b>114,144,562</b>	<b>58,728,755</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 141,077,128</b>	<b>\$ 74,421,907</b>

See the accompanying notes to unaudited condensed consolidated financial statements.

**ARENA RESOURCES, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
<b>Oil and Gas Revenues</b>	\$ 18,192,860	\$ 7,937,785	\$ 43,263,323	\$ 16,481,074
<b>Costs and Operating Expenses</b>				
Oil and gas production costs	1,455,453	946,380	4,124,281	2,384,816
Oil and gas production taxes	1,067,114	569,330	2,673,768	1,230,444
Depreciation, depletion and amortization	1,791,681	645,908	4,253,142	1,550,791
Accretion expense	41,755	25,158	104,697	74,484
General and administrative expense	1,154,243	285,828	2,626,659	898,195
<b>Total Costs and Operating Expenses</b>	5,510,246	2,472,604	13,782,547	6,138,730
<b>Other Income (Expense)</b>				
Gain from change in fair value of put options	-	20,627	-	86,497
Other financing expense	-	-	(785,598)	-
Interest income (expense)	135,272	(19,266)	40,009	(189,541)
<b>Net Other Income (Expense)</b>	135,272	1,361	(745,589)	(103,044)
<b>Income Before Provision for Income Taxes</b>	12,817,886	5,466,542	28,735,187	10,239,300
<b>Provision for Deferred Income Taxes</b>	(4,811,062)	(2,022,543)	(10,700,463)	(3,793,502)
<b>Net Income</b>	\$ 8,006,824	\$ 3,443,999	\$ 18,034,724	\$ 6,445,798
<b>Basic Net Income Per Common Share</b>	0.55	0.30	1.30	0.61
<b>Diluted Net Income Per Common Share</b>	0.51	0.27	1.22	0.53

See the accompanying notes to unaudited condensed consolidated financial statements.

**ARENA RESOURCES, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(UNAUDITED)**

<i>For the Nine Months Ended September 30,</i>	<b>2006</b>	<b>2005</b>
<b>Cash Flows From Operating Activities</b>		
Net income	\$ 18,034,724	\$ 6,445,798
Adjustments to reconcile net income to net cash provided by operating activities:		
Warrants issued for financing expense	785,598	-
Depreciation, depletion and amortization	4,253,142	1,550,791
Provision for income taxes	10,700,463	3,793,502
Gain from change in fair value of put option	-	(86,497)
Stock based compensation	656,919	95,113
Accretion of discounted liabilities	104,697	74,484
Changes in assets and liabilities:		
Accounts and joint interest receivable	(4,357,303)	(1,719,545)
Prepaid expenses	(156,476)	-
Income taxes payable and deferred income taxes	(320,058)	-
Excess tax benefits from share-based payment arrangements	(1,851,813)	-
Accounts payable and accrued liabilities	2,410,618	(295,567)
<b>Net Cash Provided by Operating Activities</b>	<b>30,260,511</b>	<b>9,858,079</b>
<b>Cash Flows from Investing Activities</b>		
Purchase and development of oil and gas properties	(61,556,302)	(18,021,414)
Purchase of machinery and equipment	(717,818)	(41,874)
<b>Net Cash Used in Investing Activities</b>	<b>(62,274,120)</b>	<b>(18,063,288)</b>
<b>Cash Flows From Financing Activities</b>		
Proceeds from issuance of common stock, net	29,788,881	9,916,749
Proceeds from exercise of warrants, net of offering costs	150,000	13,605,728
Proceeds from exercise of options	640,000	-
Excess tax benefits from share-based payment arrangements	1,851,813	-
Funds received and held for call options	1,272,093	-
Funds paid from funds held for call options	(1,265,912)	-
Proceeds from issuance of notes payable	11,000,000	-
Payment of notes payable	(11,000,000)	(10,000,000)
<b>Net Cash Provided by Financing Activities</b>	<b>32,436,875</b>	<b>13,522,477</b>
<b>Net Increase in Cash</b>	<b>423,266</b>	<b>5,317,268</b>
<b>Cash at Beginning of Period</b>	<b>4,317,114</b>	<b>1,253,969</b>
<b>Cash at End of Period</b>	<b>\$ 4,740,380</b>	<b>\$ 6,571,237</b>
<b>Supplemental Cash Flow Information</b>		
Cash paid for income taxes	\$ 329,986	\$ 73,641
Cash paid for interest	180,702	189,541
<b>Non-Cash Investing and Financing Activities</b>		
Common stock issued for properties and equipment	\$ 3,507,872	\$ 340,650
Asset retirement obligation incurred in property development	189,326	28,090

See the accompanying notes to unaudited condensed consolidated financial statements.





ARENA RESOURCES, INC.  
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2006

**NOTE 1 BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES**

**Condensed Consolidated Financial Statements** The accompanying condensed consolidated financial statements have been prepared by the Company and are unaudited. In the opinion of management, the accompanying unaudited financial statements contain all adjustments necessary for fair presentation, consisting of normal recurring adjustments, except as disclosed herein.

The accompanying unaudited interim financial statements have been condensed pursuant to the rules and regulations of the Securities and Exchange Commission; therefore, certain information and disclosures generally included in financial statements have been condensed or omitted. The condensed financial statements should be read in conjunction with the Company's annual financial statements included in its annual report on Form 10-K as of December 31, 2005. The financial position and results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of the results to be expected for the full year ending December 31, 2006.

**Nature of Operations** Arena Resources, Inc. (the Company) owns interests in oil and gas properties located in Oklahoma, Texas, Kansas and New Mexico. The Company is engaged primarily in the acquisition, exploration and development of oil and gas properties and the production and sale of oil and gas. In 2006, the Company formed a wholly owned subsidiary, Arena Drilling Co, which was formed to oversee the operation of the Company's drilling rig that began operating in May 2006.

**Consolidation** The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiary. All significant intercompany balances and transactions have been eliminated in consolidation.

**Use of Estimates** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Oil and Gas Properties** The Company uses the full cost method of accounting for oil and gas properties. Under this method, all costs associated with acquisition, exploration, and development of oil and gas reserves are capitalized. Costs capitalized include acquisition costs, geological and geophysical expenditures, lease rentals on undeveloped properties and costs of drilling and equipping productive and non-productive wells. Drilling costs include directly related overhead costs. Capitalized costs are categorized either as being subject to amortization or not subject to amortization.

All capitalized costs of oil and gas properties, including the estimated future costs to develop proved reserves and estimated future costs of abandonment and site restoration, are amortized on the unit-of-production method using estimates of proved reserves as determined by independent engineers. Investments in unproved properties and major development projects are not amortized until proved reserves associated with the projects can be determined. The Company evaluates oil and gas properties for impairment at least quarterly. Amortization expense for the three and nine months ended September 30, 2006 was \$1,791,681 and \$4,253,142, respectively, based on depletion at the rate of \$5.76 per barrel of oil equivalent compared to \$645,908 and \$1,550,791 based on depletion at the rate of \$4.52 per barrel of oil equivalent for the three and nine months ended September 30, 2005, respectively. These amounts include \$59,475 and \$5,121 for the three months ended September 30, 2006 and 2005, respectively and \$107,826 and \$13,936 of depreciation on equipment during the nine months ended September 30, 2006 and 2005, respectively.

**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2006**

In addition, capitalized costs are subject to a ceiling test which limits such costs to the estimated present value of future net revenues from proved reserves, discounted at a 10-percent interest rate, based on current economic and operating conditions, plus the lower of cost or fair market value of unproved properties. Consideration received from sales or transfers of oil and gas property is accounted for as a reduction of capitalized costs. Revenue is not recognized in connection with contractual services performed in connection with properties in which the Company holds an ownership interest.

**Income Per Common Share** Basic income per common share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted income per share reflects the potential dilution that could occur if all contracts to issue common stock were converted into common stock, except for those that are anti-dilutive.

**Concentration of Credit Risk and Major Customer** The Company currently has cash in excess of federally insured limits at September 30, 2006. During the nine months ended September 30, 2006, sales to one customer represented 82% of oil and gas revenues. At September 30, 2006, this customer made up 83% of accounts receivable.

**Stock-Based Employee Compensation** Effective January 1, 2006, the Company adopted SFAS 123R, using the modified prospective method. SFAS 123R requires the recognition of the cost of employee services received in exchange for an award of equity instruments in the financial statements and is measured based on the grant date fair value of the award. SFAS 123R also requires the stock option compensation expense to be recognized over the period during which an employee is required to provide service in exchange for the award (the vesting period). Prior to our adopting SFAS 123R, the Company accounted for stock-based compensation plans under Accounting Principles Board Opinion ( APB ) No. 25, Accounting for Stock Issued to Employees ( APB 25 ). Under APB 25, no compensation expense is recorded when the terms of the award are fixed and the exercise price of the employee stock option equals or exceeds the fair value of the underlying stock on the date of grant.

For the three and nine months ended September 30, 2006, the Company recorded compensation expense of \$263,619 and \$656,919 related to stock options.

The Company granted 50,000 stock options during the nine months ended September 30, 2006 and granted 375,000 stock options during the nine months ended September 30, 2005. The weighted average fair value per share of stock options at the date of grant during the nine months ended September 30, 2006 and 2005 was \$17.53 and \$3.01, respectively.

The following are the weighted-average assumptions used for options granted during the nine months ended September 30, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Risk free interest rate	4.92%	3.64%
Expected life	5 Years	5 Years
Dividend yield	-	-
Volatility	44%	33%

**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2006**

The expected life of stock options represents the period of time that the stock options granted are expected to be outstanding based on historical exercise trends. The expected volatility is based on the historical price volatility of our common stock. The risk-free interest rate represents the U.S. Treasury bill rate for the expected life of the related stock options. The dividend yield represents our anticipated cash dividend over the expected life of the stock options.

A summary of stock option activity for the nine months ended September 30, 2006 is presented below:

	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding at January 1, 2006	1,425,000	\$ 6.29		
Granted	50,000	27.40		
Exercised	(170,000)	3.76		
Outstanding at September 30, 2006	1,305,000	\$ 6.62	2.7 years	\$ 33,276,600
Exercisable at September 30, 2006	505,000	\$ 4.43	2.3 years	\$ 13,985,100

A summary of the status of the Company's non-vested stock options as of and for the nine months ended September 30, 2006 is presented below

	Non-Vested Options	Weighted Average Grant Date Fair Value
Non-vested at January 1, 2006	1,025,000	\$ 2.50
Granted	50,000	17.53
Vested	(275,000)	2.18
Non-vested at September 30, 2006	800,000	\$ 3.55

As of September 30, 2006, there was approximately \$1,445,728 of unrecognized compensation cost related to stock options that will be recognized through June 2011.

Prior to January 1, 2006, the Company determined the value of stock-based compensation arrangements under the provisions of APB Opinion No. 25 "Accounting for Stock Issued to Employees" and made pro forma disclosures required under SFAS No. 123, "Accounting for Stock-Based Compensation." Had compensation expense for stock option grants been determined based on the fair value at the grant dates consistent with the method prescribed in FASB 123, the Company's net loss and net loss per share would have been adjusted to the proforma amounts below for the three and nine months ended September 30, 2005, as indicated below:

**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2006**

	<b>For the Three Months Ended September 30, 2005</b>		<b>For the Nine Months Ended September 30, 2005</b>	
Net income, as reported	\$	3,443,999	\$	6,445,798
Add: Stock based employee compensation expense included in net income, net of related tax effects		16,208		59,635
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects		(124,385)		(402,818)
<b>Pro Forma Net Income</b>	<b>\$</b>	<b>3,335,822</b>	<b>\$</b>	<b>6,102,615</b>
<b>Income per Common Share</b>				
Basic, as reported	\$	0.30	\$	0.61
Basic, pro forma		0.29		0.58
Diluted, as reported		0.27		0.53
Diluted, pro forma		0.26		0.51

**NOTE 2 EARNINGS PER SHARE INFORMATION**

	<b>Three Months Ended September 30, 2006</b>		<b>September 30, 2005</b>		<b>Nine Months Ended September 30, 2006</b>		<b>2005</b>	
Net Income	\$	8,006,824	\$	3,443,999	\$	18,034,724	\$	6,445,798
Basic Weighted-Average Common Shares Outstanding		14,625,789		11,491,994		13,865,528		10,554,879
Effect of dilutive securities								
Warrants		234,542		967,985		256,402		984,055
Stock options		719,411		522,273		705,609		522,273
Diluted Weighted-Average Common Shares Outstanding		15,579,742		12,982,252		14,827,539		12,061,207
Basic Income Per Common Share		0.55		0.30		1.30		0.61
Diluted Income Per Common Share		0.51		0.27		1.22		0.53

For the three and nine months ended September 30, 2006, 50,000 stock options were not included in the computation of diluted income per share as their effects are anti-dilutive.

**NOTE 3 ACQUISITION OF OIL AND GAS PROPERTIES**

In January 2006, the Company entered into a definitive agreement to reacquire the working interests and related rights in two different prospects in Comanche and Hamilton Counties, Kansas with combined acreage totaling approximately 20,000 acres. During 2005 the Company sold working interest rights in multiple wells drilled on these prospects, along with rights to participate in additional wells on the acreage. Total consideration provided for the re-acquisitions of these rights and interests was 120,800 shares of common stock, issued in February 2006, valued at \$3,326,832, or \$27.54 per share.



**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2006**

**NOTE 4 NOTES PAYABLE**

In April 2005, the Company entered into an agreement that increased its credit facility to \$50,000,000, with an increased borrowing base of \$35,000,000. The interest rate was a floating rate equal to the 30, 60 or 90 day LIBOR rate plus 2.25%, and is payable monthly. Amounts borrowed under the revolving credit facility are due in May 2009. The revolving credit facility is secured by the Company's principal mineral interests. In order to obtain the revolving credit facility, loans from two officers were subordinated to the position of the bank. The Company is required under the terms of the credit facility to maintain a tangible net worth of \$12,000,000, maintain a 5-to-1 ratio of income before interest, taxes, depreciation, depletion and amortization to interest expense and maintain a current asset to current liability ratio of 1-to-1.

In April 2006, the Company entered into a new credit agreement increasing the Company's credit facility to \$150,000,000 with a \$65,000,000 borrowing base. Additionally, this new agreement adjusted the interest rate to be equal to the 30, 60 or 90 day LIBOR rate plus 2%, removed the requirement to maintain a tangible net worth but added a requirement to a rolling four quarter basis of a maximum leverage ratio of no more than 2.5-to-1. All other conditions of the credit facility remained the same. At September 30, 2006, the Company was in compliance with all covenants and had no amounts outstanding under this credit facility, excluding \$527,500 reserved under the revolving credit facility as collateral for standby letters of credit issued to various states.

On March 31, 2006, two officers of the Company and the Board of Directors agreed to an extension of the \$400,000 notes payable to the two officers to July 1, 2008, under the same terms as the original notes.

**NOTE 5 ASSET RETIREMENT OBLIGATION**

The Company provides for the obligation to plug and abandon oil and gas wells at the dates properties are acquired or the wells are drilled. The asset retirement obligation is adjusted each quarter for any liabilities incurred or settled during the period, accretion expense and any revisions made to the estimated cash flows. The reconciliation of the asset retirement obligation for the nine months ended September 30, 2006 is as follows:

Balance, January 1, 2006	\$ 1,515,347
Liabilities incurred	189,326
Accretion expense	104,697
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Balance, September 30, 2006	\$ 1,809,370
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**NOTE 6 STOCKHOLDERS EQUITY**

**Private Placement** In May 2006, the Company issued 1,150,000 shares of common stock in a private placement for \$32,246,000. The Company paid \$2,464,619 in offering costs and underwriter's fees resulting in net proceeds from the offering of \$29,788,881. As part of the agreement, the Company agreed to register these shares which was completed in July, 2006.

**Warrants exercised** During the nine months ended September 30, 2006, the Company issued 50,000 shares of common stock upon the exercise of warrants for proceeds of \$150,000, or \$3.00 per share. Additionally, during the nine months ended September 30, 2006, the Company issued 61,885 shares of common stock in a cashless exercise of 75,462 warrants with an exercise price of \$9.00 per share and 3,461 warrants with an exercise price of \$7.49 per share.

**Options exercised** During the nine months ended September 30, 2006, the Company issued 170,000 shares of common stock upon the exercise of options for proceeds of \$640,000, or an average of \$3.76 per share. As a result of these exercises, the Company will realize an additional tax benefit in the amount of \$1,851,813, which was recorded against additional paid-in capital.

**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2006**

**Shares issued in property or equipment acquisition** In February 2006, the Company issued 120,800 shares of restricted common stock, valued at \$3,326,832, or \$27.54 per share, as partial consideration for the acquisition of working interests in the Syracuse and Rocky prospects in Comanche and Hamilton Counties, Kansas, as disclosed in Note 3.

Also in February 2006, the Company issued 6,200 shares of restricted common stock, valued at \$181,040, or \$29.20 per share, as part of the cost of a drilling rig that the Company acquired, which was placed in service in April 2006.

**Warrants issued** In connection with the July 2005 private placement of common stock, the Company committed to use its best efforts to register such shares with the Securities and Exchange Commission. The Company was unable to effect the registration within the allotted time and was required to issue warrants to acquire 29,126 shares of common stock in January 2006. The exercise price of these warrants is \$10.30 and the warrants expire in January 2011. The Company recognized an expense equal to the fair value of these warrants of \$785,598 as a result of this issuance. The fair value of the warrants was determined using the Black-Scholes option pricing model with the following assumptions: 4.44% risk-free interest rate; 43.42% expected volatility; five year expected life and 0% dividend yield.

**Options issued** During the nine months ended September 30, 2006, the Company issued 50,000 options with an original exercise price of \$34.43 per share under the Company's stock option plan. Also during the nine months ended September 30, 2006, the Company amended these options to have an exercise price of \$27.40. The original fair value of the options was \$778,357, calculated using the Black-Scholes option-pricing model with the following weighted average assumptions: dividend yield of 0%, expected volatility of 43.62%, risk-free interest rate of 4.92%, and expected lives of 5 years. As a result of the amendment the fair value increased by \$98,260, calculated using the Black-Scholes option-pricing model with the following weighted average assumptions: dividend yield of 0%, expected volatility of 44.27%, risk-free interest rate of 5.03%, and expected lives of 5 years.

**NOTE 7 CONTINGENCIES AND COMMITMENTS**

**Standby Letters of Credit** A commercial bank has issued standby letters of credit on behalf of the Company to the states of Texas, Oklahoma, New Mexico and Kansas totaling \$527,500 to allow the Company to do business in those states. The standby letters of credit are valid until cancelled or matured and are collateralized by the revolving credit facility with the bank. Letter of credit terms range from one to five years. The Company intends to renew the standby letters of credit for as long as the Company does business in those states. No amounts have been drawn under the standby letters of credit.

**NOTE 8 SUBSEQUENT EVENTS**

Subsequent to September 30, 2006, the Company has drawn \$3,000,000 on its credit facility.

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

*Results of Operations For the Three Months Ended September 30, 2006*

*Oil and natural gas sales.* For the three months ended September 30, 2006, oil and natural gas sales revenue increased \$10,255,075 to \$18,192,860, compared to \$7,937,785 for the same period during 2005. Oil sales increased \$9,101,277 and natural gas sales increased \$1,153,798. The increases were the result of our increased volumes due to our development throughout 2005 and 2006 and increased average realized sales prices. For the three months ended September 30, 2006, oil sales volume increased 132,766 barrels to 256,366 barrels, compared to 123,600 barrels for the same period in 2005. The average realized per barrel oil price increased 8% from \$58.92 for the three months ended September 30, 2005 to \$63.91 for the three months ended September 30, 2006. For the three months ended September 30, 2006, gas sales volume increased 171,252 thousand cubic feet (MCF) to 276,881 MCF, compared to 105,629 MCF for the same period in 2005. The average realized natural gas price per MCF increased 5% from \$6.20 for the three months ended September 30, 2005 to \$6.53 for the three months ended September 30, 2006.

*Oil and gas production costs.* Our lease operating expenses (LOE) increased from \$946,380 or \$6.70 per barrel of oil equivalent (BOE) for the three months ended September 30, 2005 to \$1,455,453 or \$4.81 per BOE for the three months ended September 30, 2006. The increase in total LOE was due to our development projects throughout 2005 and 2006. The decrease in the per BOE amounts is a result of increased production as a result of the development of our properties.

*Production taxes.* Production taxes as a percentage of oil and natural gas sales were 7% during the three months ended September 30, 2005 and decreased to 6% for the three months ended September 30, 2006. Production taxes vary from state to state. Therefore, these taxes may vary in the future depending on the mix of production we generate from various states, as well as the possibility that any state may raise its production tax rate.

*Depreciation, depletion and amortization.* Our depreciation, depletion and amortization expense increased by \$1,145,773 to \$1,791,681 for the three months ended September 30, 2006, compared to the same period in 2005. The increase was primarily a result of an increase in volume and in the average depletion rate from \$4.52 per BOE during the three months ended September 30, 2005 to \$5.76 per BOE during the three months ended September 30, 2006. The increased depletion rate was the result of increased capitalized costs and development costs.

*General and administrative expenses.* General and administrative expenses increased by \$868,415 to \$1,154,243 for the three months ended September 30, 2006, compared to the same period in 2005. A portion of this increase was due to the adoption of FASB 123(R) which resulted in the recognition of stock-based compensation expense of \$263,619. Additionally, the Company paid \$150,000 to the New York Stock Exchange for the initial listing fee and paid \$123,657 in insurance premiums as the result of an insurance audit. The remaining increase was primarily related to increases in compensation expense associated with an increase in personnel required to administer our growth.

*Net interest income or expense.* Net interest income was \$135,272 for the three months ended September 30, 2006, compared to net interest expense of \$19,266 for the three months ended September 30, 2005. This was due to a combination of lower average outstanding debt over the full quarter and interest income on our excess cash.

*Income tax expense.* Our effective tax rate was 37% during the three months ended September 30, 2005 and remained steady at 37% for the three months ended September 30, 2006.



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*Net income.* Net income increased from \$3,443,999 for the three months ended September 30, 2005 to \$8,006,824 for the same period in 2006. The primary reasons for this increase include increased volumes as a result of the development of our properties and higher crude oil prices between periods, partially offset by higher lease operating expense, general and administrative expense and income tax expense due to our growth.

### *Results of Operations For the Nine Months Ended September 30, 2006*

*Oil and natural gas sales.* For the nine months ended September 30, 2006, oil and natural gas sales revenue increased \$26,782,249 to \$43,263,323, compared to \$16,481,074 for the same period during 2005. Oil sales increased \$24,133,727 and natural gas sales increased \$2,648,522. The increases were the result of our increased volumes due to our development throughout 2005 and 2006 and increased average realized sales prices. For the nine months ended September 30, 2006, oil sales volume increased 338,361 barrels to 631,455 barrels, compared to 293,094 barrels for the same period in 2005. The average realized per barrel oil price increased 21% from \$51.05 for the nine months ended September 30, 2005 to \$61.91 for the nine months ended September 30, 2006. For the nine months ended September 30, 2006, gas sales volume increased 343,833 MCF to 617,745 MCF, compared to 273,912 MCF for the same period in 2005. The average realized natural gas price per MCF increased 22% from \$5.55 for the nine months ended September 30, 2005 to \$6.75 for the nine months ended September 30, 2006.

*Oil and gas production costs.* Our lease operating expenses (LOE) increased from \$2,384,816 or \$7.04 per BOE for the nine months ended September 30, 2005 to \$4,124,281 or \$5.62 per BOE for the nine months ended September 30, 2006. The increase in total LOE was due to our development projects throughout 2005 and 2006. The decrease in the per BOE amounts is a result of increased production as a result of the development of our properties.

*Production taxes.* Production taxes as a percentage of oil and natural gas sales were 7% during the nine months ended September 30, 2005 and decreased to 6% for the nine months ended September 30, 2006. Production taxes vary from state to state. Therefore, these taxes may vary in the future depending on the mix of production we generate from various states, as well as the possibility that any state may raise its production tax rate.

*Depreciation, depletion and amortization.* Our depreciation, depletion and amortization expense increased by \$2,702,351 to \$4,253,142 for the nine months ended September 30, 2006, compared to the same period in 2005. The increase was primarily a result of an increase in volume and in the average depletion rate from \$4.52 per BOE during the nine months ended September 30, 2005 to \$5.76 per BOE during the nine months ended September 30, 2006. The increased depletion rate was the result of increased capitalized costs and development costs.

*General and administrative expenses.* General and administrative expenses increased by \$1,728,464 to \$2,626,659 for the nine months ended September 30, 2006, compared to the same period in 2005. A portion of this increase was due to the adoption of FASB 123(R) which resulted in the recognition of stock-based compensation expense of \$656,919. Additionally, the Company paid \$150,000 to the New York Stock Exchange for the initial listing fee and paid \$123,657 in insurance premiums as the result of an insurance audit. The remaining increase was primarily related to increases in compensation expense associated with an increase in personnel required to administer our growth.

*Other financing expense.* Other financing expense was \$785,598 for the nine months ended September 30, 2006, compared to \$0 for the same period in 2005. This financing expense relates to the issuance in the first quarter of 2006 of warrants associated with the 2005 private offering and subsequent registration of common stock.

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*Net interest income or expense.* Net interest income was \$40,009 for the nine months ended September 30, 2006, compared to net interest expense of \$189,541 for the nine months ended September 30, 2005. This was due to a combination of lower average outstanding debt over the full nine months and interest income on our excess cash.

*Income tax expense.* Our effective tax rate was 37% during the nine months ended September 30, 2005 and remained steady at 37% for the nine months ended September 30, 2006.

*Net income.* Net income increased from \$6,445,798 for the nine months ended September 30, 2005 to \$18,034,724 for the same period in 2006. The primary reasons for this increase include increased volumes as a result of the development of our properties and higher crude oil prices between periods, partially offset by higher lease operating expense, general and administrative expense and income tax expense due to our growth.

### *Revenues Year to Date by Geographic section*

Arena reports its net oil and gas revenues for the year to date as applicable to the following geographic sectors:

#### **OIL**

	Net Production Volume	Net Revenue
Texas Leases	423,588 BBLS	\$ 26,187,982
Oklahoma Leases	38,628 BBLS	\$ 2,547,897
New Mexico Leases	169,239 BBLS	\$ 10,359,878

#### **GAS**

	Net Production Volume	Net Revenue
Texas Leases	252,023 MCF	\$ 1,840,967
Oklahoma Leases	20,416 MCF	\$ 92,012
New Mexico Leases	182,551 MCF	\$ 1,555,175
Kansas	162,755 MCF	\$ 679,412

### *Significant Subsequent Events occurring after September 30, 2006:*

Subsequent to September 30, 2006, the Company has drawn \$3,000,000 on its credit facility.

### *Capital Resources and Liquidity*

As shown in the financial statements for the nine months ended September 30, 2006, the Company had cash on hand of \$4,740,380, compared to \$4,317,114 as of December 31, 2005. The Company had positive net cash flows from operations for the nine months ended September 30, 2006 of \$30,260,512, compared to \$9,858,079 for the same period 2005. Other significant sources of cash inflow were \$11,000,000 drawn down on the Company's credit facility and net proceeds from a private placement of \$29,788,881 in 2006 and \$9,916,749 net proceeds from a private placement and \$13,605,728 net proceeds from the exercise of warrants in 2005. The most significant cash outflows during the nine months ended September 30, 2006 and 2005 were capital expenditures of \$61,556,302 in 2006 and \$18,021,414 in 2005 and repayment of debt on the Company's credit facility of \$11,000,000 in 2006 and \$10,000,000 in 2005.

In April 2005, the Company entered into an agreement that increased its credit facility to \$50,000,000, with an increased borrowing base of \$35,000,000. The interest rate was a floating rate equal to the 30, 60 or 90 day LIBOR rate plus 2.25%, and is payable monthly. Amounts borrowed under the revolving credit facility are due in May 2009. The revolving credit facility is secured by the Company's principal mineral interests. In order to obtain the revolving credit facility, loans from two officers were subordinated to the position of the bank. The Company is required under the terms of the credit facility to maintain a tangible net worth of \$12,000,000, maintain a 5-to-1 ratio of income before interest, taxes, depreciation, depletion and amortization to interest expense and maintain a current asset to current liability ratio of 1-to-1.

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In April 2006, the Company entered into a new credit agreement increasing the Company's credit facility to \$150,000,000 with a \$65,000,000 borrowing base. Additionally, this new agreement adjusted the interest rate to be equal to the 30, 60 or 90 day LIBOR rate plus 2%, removed the requirement to maintain a tangible net worth but added a requirement to a rolling four quarter basis of a maximum leverage ratio of no more than 2.5-to-1. All other conditions of the credit facility remained the same. At September 30, 2006, the Company was in compliance with all covenants and had no amounts outstanding under this credit facility, excluding \$527,500 reserved under the revolving credit facility as collateral for standby letters of credit issued to various states.

### *Disclosures About Market Risks*

Like other natural resource producers, Arena faces certain unique market risks. The two most salient risk factors are the volatile prices of oil and gas and certain environmental concerns and obligations.

#### Oil and Gas Prices

Current competitive factors in the domestic oil and gas industry are unique. The actual price range of crude oil is largely established by major international producers. Pricing for natural gas is more regional. Because domestic demand for oil and gas exceeds supply, there is little risk that all current production will not be sold at relatively fixed prices. To this extent Arena does not see itself as directly competitive with other producers, nor is there any significant risk that the Company could not sell all production at current prices with a reasonable profit margin. The risk of domestic overproduction at current prices is not deemed significant. The primary competitive risks would come from falling international prices which could render current production uneconomical.

Secondarily, Arena is presently committed to use the services of the existing gatherers in its present areas of production. This gives to such gatherers certain short term relative monopolistic powers to set gathering and transportation costs, because obtaining the services of an alternative gathering company would require substantial additional costs since an alternative gatherer would be required to lay new pipeline and/or obtain new rights-of-way in the lease.

It is also significant that more favorable prices can usually be negotiated for larger quantities of oil and/or gas product, such that Arena views itself as having a price disadvantage to larger producers. Large producers also have a competitive advantage to the extent they can devote substantially more resources to acquiring prime leases and resources to better find and develop prospects.

#### Environmental

Oil and gas production is a highly regulated activity which is subject to significant environmental and conservation regulations both on a federal and state level. Historically, most of the environmental regulation of oil and gas production has been left to state regulatory boards or agencies in those jurisdictions where there is significant gas and oil production, with limited direct regulation by such federal agencies as the Environmental Protection Agency. However, while the Company believes this generally to be the case for its production activities in Texas, Oklahoma, Kansas and New Mexico, it should be noticed that there are various Environmental Protection Agency regulations which would govern significant spills, blow-outs, or uncontrolled emissions.

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In Oklahoma, Texas, Kansas and New Mexico specific oil and gas regulations exist related to the drilling, completion and operations of wells, as well as disposal of waste oil. There are also procedures incident to the plugging and abandonment of dry holes or other non-operational wells, all as governed by the Oklahoma Corporation Commission, Oil and Gas Division, the Texas Railroad Commission, Oil and Gas Division, the Kansas Corporation Commission, Oil and Gas Division or the New Mexico Oil Conservation Division.

Compliance with these regulations may constitute a significant cost and effort for Arena. No specific accounting for environmental compliance has been maintained or projected by Arena to date. Arena does not presently know of any environmental demands, claims, or adverse actions, litigation or administrative proceedings in which it or the acquired properties are involved or subject to or arising out of its predecessor operations.

In the event of a breach of environmental regulations, these environmental regulatory agencies have a broad range of alternative or cumulative remedies to include: ordering a clean up of any spills or waste material and restoration of the soil or water to conditions existing prior to the environmental violation; fines; or enjoining further drilling, completion or production activities. In certain egregious situations the agencies may also pursue criminal remedies against the Company or its principals.

### *Forward-Looking Information*

Certain statements in this Section and elsewhere in this report are forward-looking in nature and relate to trends and events that may affect the Company's future financial position and operating results. Such statements are made pursuant to the safe harbor provision of the *Private Securities Litigation Reform Act of 1995*. The terms expect, anticipate, intend, and project and similar words or expressions are intended to identify forward-looking statements. These statements speak only as of the date of this report. The statements are based on current expectations, are inherently uncertain, are subject to risks, and should be viewed with caution. Actual results and experience may differ materially from the forward-looking statements as a result of many factors, including changes in economic conditions in the markets served by the company, increasing competition, fluctuations in raw materials and energy prices, and other unanticipated events and conditions. It is not possible to foresee or identify all such factors. The company makes no commitment to update any forward-looking statement or to disclose any facts, events, or circumstances after the date hereof that may affect the accuracy of any forward-looking statement.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

#### *Interest Rate Risk*

The Company is subject to interest rate risk on its revolving credit facility, which bears variable interest based upon a LIBOR rate. Changes in interest rates affect the interest earned on the Company's cash and cash equivalents and the interest rate paid on borrowings under its bank credit facility. Currently, the Company does not use interest rate derivative instruments to manage exposure to interest rate changes.

#### *Commodity Price Risk*

The Company's revenues, profitability and future growth depend substantially on prevailing prices for oil and natural gas. Prices also affect the amount of cash flow available for capital expenditures and Arena's ability to borrow and raise additional capital. The amount the Company can borrow under its bank credit facility is subject to periodic redetermination based in part on changing expectations of future prices. Lower prices may also reduce the amount of oil and natural gas that the Company can economically produce. Arena currently sells all of its oil and natural gas production under price sensitive or market price contracts.

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Arena does not currently use derivative commodity instruments or similar financial instruments to attempt to hedge commodity price risks associated with future oil and natural gas production.

### *Currency Exchange Rate Risk*

Foreign sales accounted for none of the Company's sales; further, the Company accepts payment for its commodity sales only in U.S. dollars; hence, Arena is not exposed to foreign currency exchange rate risk on these sales.

## **Item 4. Controls and Procedures**

### *Evaluation of Disclosure Controls and Procedures*

The Company maintains controls and procedures designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. At the end of the period covered by this Quarterly Report on Form 10-Q, the Company's management, under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that as of the end of such period the Company's disclosure control and procedures are effective in alerting them to material information that is required to be included in the reports the Company files or submits under the Securities Exchange Act of 1934.

### *Changes in Internal Controls Over Financial Reporting*

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

**Part II Other Information**

**Item 1. Legal Proceedings**

None.

**Item 1A. Risk Factors**

Subsequent to filing our annual report on Form 10-K on March 16, 2006, we filed a registration statement on Form S-3, which contains a risk factor that is in addition to those contained in Item 1A of our Form 10-K. This additional risk factor is set forth below.

**The unavailability or high cost of drilling rigs, equipment, supplies, personnel and oil field services could adversely affect our ability to execute on a timely basis our exploration and development plans within our budget.**

With the recent increase in the prices of oil and natural gas, we have encountered an increase in the cost of securing drilling rigs, equipment and supplies. Shortages or the high cost of drilling rigs, equipment, supplies and personnel are expected to continue in the near-term. In addition, larger producers may be more likely to secure access to such equipment by virtue of offering drilling companies more lucrative terms. If we are unable to acquire access to such resources, or can obtain access only at higher prices, not only would this potentially delay our ability to convert our reserves into cash flow, but could also significantly increase the cost of producing those reserves, thereby negatively impacting anticipated net income.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

- |     |                     |                                   |
|-----|---------------------|-----------------------------------|
| (a) | <u>Exhibit 31.1</u> | Section 302 Certification of CEO  |
|     | <u>Exhibit 31.2</u> | Section 302 Certification of CFO  |
| (b) | <u>Exhibit 32.1</u> | Section 1350 Certification of CEO |
|     | <u>Exhibit 32.2</u> | Section 1350 Certification of CFO |



**SIGNATURES**

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

REGISTRANT: **ARENA RESOURCES, INC.**

Dated: November 3, 2006

By: /s/ Lloyd Tim Rochford  
Lloyd Tim Rochford  
President, Chief Executive Officer

Dated: November 3, 2006

By: /s/ Stanley McCabe  
Stanley McCabe  
Treasurer, Secretary

Dated: November 3, 2006

By: /s/ William R. Broaddrick  
William R. Broaddrick  
Vice President, Chief Financial Officer