

GEOPETRO RESOURCES CO  
Form 10-Q  
August 08, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended June 30, 2008

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 001-16749

## GeoPetro Resources Company

(Exact name of registrant as specified in its charter)

**California**

(State of incorporation)

**94-3214487**

(IRS Employer Identification Number)

**One Maritime Plaza, Suite 700**

**San Francisco, CA**

(Address of principal executive offices)

**94111**

(Zip Code)

**(415) 398-8186**

(Registrant's telephone number, including area code)

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

There were 32,784,646 shares of no par value common stock outstanding on August 7, 2008.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements.

## GEOPETRO RESOURCES COMPANY

## UNAUDITED CONSOLIDATED BALANCE SHEETS

	June 30, 2008	December 31, 2007
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 4,517,792	\$ 4,294,565
Trade accounts receivable oil and gas sales	877,607	965,188
Accounts receivable other	69,321	345,862
Prepaid expenses	220,499	118,065
<b>Total current assets</b>	<b>5,685,219</b>	<b>5,723,680</b>
<b>Oil and gas properties, at cost (full cost method):</b>		
Unevaluated properties	8,480,457	5,848,195
Evaluated properties	47,903,241	47,428,750
Less accumulated depletion and impairment	(15,955,307)	(14,917,700)
<b>Net oil and gas properties</b>	<b>40,428,391</b>	<b>38,359,245</b>
<b>Furniture, fixtures and equipment, at cost, net of depreciation</b>	<b>19,531</b>	<b>26,727</b>
<b>Other assets deposits and other noncurrent assets</b>	<b>7,436</b>	<b>6,954</b>
<b>Total Assets</b>	<b>\$ 46,140,577</b>	<b>\$ 44,116,606</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
<b>Current Liabilities:</b>		
Trade accounts payable	\$ 940,713	\$ 666,293
Production taxes payable	237,467	407,246
Other taxes payable	2,873	161,032
Royalty owners payable	1,429,894	979,743
Net profits interest payable	355,679	147,513
<b>Total current liabilities</b>	<b>2,966,626</b>	<b>2,361,827</b>
<b>Asset Retirement Obligations</b>	<b>56,349</b>	<b>53,726</b>
<b>Commitments and Contingencies (Notes 2 and 8)</b>		
<b>Shareholders Equity:</b>		
Common stock, no par value; 100,000,000 shares authorized; 32,700,970 and 31,950,970 shares issued and outstanding at June 30, 2008 and December 31, 2007, respectively	51,867,733	51,492,733
Additional paid-in capital	2,279,820	2,219,109
Accumulated deficit	(11,029,951)	(12,010,789)

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Total shareholders' equity	43,117,602	41,701,053
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 46,140,577</b>	<b>\$ 44,116,606</b>

*See accompanying notes to these unaudited consolidated financial statements.*

Table of Contents**GEOPETRO RESOURCES COMPANY****UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS**

	<b>Three Months Ended June 30,</b>		<b>Six months Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
	<b>(Unaudited)</b>	<b>(Unaudited)</b>	<b>(Unaudited)</b>	<b>(Unaudited)</b>
<b>Revenues</b>				
Oil and gas sales	\$ 2,650,992	\$ 2,388,850	\$ 4,793,590	\$ 4,212,192
Costs and expenses:				
Lease operating expense	646,559	418,830	990,382	846,107
General and administrative	604,090	767,563	1,319,513	1,526,919
Net profits interest	260,868	244,384	488,929	428,588
Impairment expense	63,766		63,766	
Depreciation and depletion expense	448,305	652,928	982,735	1,229,870
Total costs and expenses	2,023,588	2,083,705	3,845,325	4,031,484
Income from operations	627,404	305,145	948,265	180,708
Other Income and (Expense):				
Interest expense		(92,263)		(178,445)
Interest income	17,803	28,196	47,868	56,201
Total other income (expense)	17,803	(64,067)	47,868	(122,244)
Net Income Before Taxes	645,207	241,078	996,133	58,464
Income tax expense	(8,495)	(2,300)	(15,295)	(2,300)
Net Income After Taxes	636,712	238,778	980,838	56,164
Net Income Available to Common Shareholders	\$ 636,712	\$ 238,778	\$ 980,838	\$ 56,164
Earnings per Share:				
Basic	\$ 0.02	\$ 0.01	\$ 0.03	\$ 0.00
Diluted	\$ 0.02	\$ 0.01	\$ 0.03	\$ 0.00
Weighted Average Number of Common Shares				
Outstanding:				
Basic	32,503,168	29,483,676	32,227,069	28,510,691
Diluted	33,139,460	32,068,422	33,174,998	30,897,006

*See accompanying notes to these unaudited consolidated financial statements*



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## GEOPETRO RESOURCES COMPANY

## UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Six Months Ended	
	June 30, 2008	June 30, 2007
<b>Cash Flows From Operating Activities:</b>		
Net income	\$ 980,838	\$ 56,164
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and depletion	982,735	1,229,870
Share-based compensation expense	60,711	69,870
Non-cash interest expense		108,223
Impairment expense	63,766	
Accretion of discount on asset retirement obligations	2,098	1,430
Changes in operating assets and liabilities:		
(Increase) decrease in accounts receivable	87,581	(308,189)
Decrease in other current assets	173,625	16,391
Increase (decrease) in other current liabilities	604,801	(233,609)
Increase in other long term liabilities	525	953
Net cash provided by operating activities	2,956,680	941,103
<b>Cash Flows from Investing Activities:</b>		
Oil and gas property expenditures	(3,106,752)	(1,430,493)
Acquisition of furniture, fixtures & equipment	(1,701)	(5,881)
Decrease in related party notes receivable		1,000,000
Net cash used in investing activities	(3,108,453)	(436,374)
<b>Cash Flows from Financing Activities:</b>		
Proceeds from sale of common shares, option and warrant exercises, net	375,000	620,644
Proceeds from promissory notes, net		1,000,000
Payments of loan fee		(57,000)
Repayments of promissory notes		(100,000)
Net cash provided by financing activities	375,000	1,463,644
<b>Net Increase in Cash and Cash Equivalents:</b>	223,227	1,968,373
<b>Cash and Cash Equivalents:</b>		
Beginning of period	4,294,565	734,561
End of period	\$ 4,517,792	\$ 2,702,934
<b>Supplemental Disclosure of Cash Flow Information:</b>		
Cash paid for interest	\$	\$ 70,222
Cash paid for income taxes	\$ 15,295	\$

*See accompanying notes to these unaudited consolidated financial statements.*





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**GEOPETRO RESOURCES COMPANY**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**1. BASIS OF PRESENTATION AND USE OF ESTIMATES:**

The interim consolidated financial statements of GeoPetro Resources Company ( we, us, our, GeoPetro or the Company ) are unaudited and contain all adjustments (consisting primarily of normal recurring accruals) necessary for a fair statement of the results for the interim periods presented. Results for interim periods are not necessarily indicative of results to be expected for a full year or for previously reported periods due in part, but not limited to, the volatility in crude oil and natural gas commodity prices, interest rates, estimates of reserves, drilling risks, geological risks, transportation restrictions, the timing of acquisitions, product demand, market competition, interruption in production and our ability to obtain additional capital. You should read these consolidated interim financial statements in conjunction with the audited consolidated financial statements and notes thereto included in GeoPetro's Annual Report on Form 10-K for the year ended December 31, 2007.

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) and include the accounts of GeoPetro and its wholly-owned subsidiaries. Intercompany accounts and transactions are eliminated. In preparing the accompanying financial statements, management has made certain estimates and assumptions that affect reported amounts in the financial statements. Actual results may differ from those estimates. Significant assumptions are required in the valuation of proved oil and natural gas reserves, which may affect the amount at which oil and natural gas properties are recorded. The computation of share-based compensation expense requires assumptions such as volatility, expected life and the risk-free interest rate. It is at least reasonably possible these estimates could be revised in the near term, and these revisions could be material.

Certain reclassifications have been made to prior period financial statements to conform with the current presentation.

**2. LIQUIDITY:**

We hold working interests in undeveloped leases, seismic options, lease options and foreign concessions and we have participated in seismic surveys and the drilling of test wells on undeveloped properties. Further leasehold acquisitions and seismic operations are planned for 2008 and future periods. In addition, exploratory and developmental drilling is scheduled during 2008 and future periods on our undeveloped properties. We anticipate that these exploration activities together with others that may be entered into may impose financial requirements which may exceed our existing working capital. We may need to raise additional equity or enter into new borrowing arrangements to finance our continued participation in planned activities. Further, we have farmed-out certain of our projects. However, if additional financing is not available, we may be compelled to reduce the scope of our business activities. If we are unable to fund planned expenditures, it may be necessary to forfeit our interest in proposed wells, farm-out our interest in proposed wells, sell a portion of our interests in prospects and use the sale proceeds to fund participation for a lesser interest, reduce general and administrative expenses, or a combination of all of these factors.

**3. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS:**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which we adopted on January 1, 2008. SFAS 157 provides a definition of fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements for future transactions. The adoption of this pronouncement did not impact our financial position or results of operations.

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In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ( SFAS No. 141R ). SFAS No. 141R, which among other things, establishes principles and requirements for how the acquirer in a business combination (i) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquired business, (ii) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (iii) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141R is effective for fiscal years beginning on or after December 15, 2008, with early adoption prohibited. This standard will change our accounting treatment for business combinations on a prospective basis.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51* ( SFAS No. 160 ). SFAS No. 160 establishes accounting and reporting standards for noncontrolling interests in a subsidiary and for the deconsolidation of a subsidiary. Minority interests will be recharacterized as noncontrolling interests and classified as a component of equity. It also establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary and requires expanded disclosures. This statement is effective for fiscal years beginning on or after December 15, 2008, with early adoption prohibited. We do not expect the adoption of this statement will have a material impact on our financial position or results of operations.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, an amendment of FASB Statement No. 133. SFAS 161 amends and expands the disclosure requirements of FASB Statement No. 133 with the intent to provide users of financial statement with an enhanced understanding of (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and the related hedged items are accounted for under FASB Statement No. 133 and its related interpretations, and (iii) how derivative instruments and related hedged items affect and entity's financial position, financial performance and cash flows. SFAS No. 161 is effective for financial statements issued for years and interim periods beginning after November 15, 2008. We do not expect the adoption of SFAS No. 161 to have a significant effect on our reported financial position or results of operations.

**4. EARNINGS PER COMMON SHARE:**

Basic earnings per share excludes dilution and is calculated by dividing net income or loss by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared from the earnings of the entity. There were 2,196,230 and 196,375 outstanding common stock warrants as well as 990,000 and 20,000 outstanding common stock options at June 30, 2008 and June 30, 2007, respectively, that were not included in the diluted EPS calculation because the warrants and options exercise prices were greater than the average market price of the common shares.

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	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
<b>Numerators:</b>				
Net Income Available to Common Shareholders	\$ 636,712	\$ 238,778	\$ 980,838	\$ 56,164
<b>Denominator:</b>				
Weighted Average Shares Outstanding	32,503,168	29,483,676	32,227,069	28,510,691
Outstanding Options	585,651	2,237,546	889,226	2,123,329
Outstanding Warrants	50,641	347,200	58,703	262,986
Average Number of Shares for Diluted Calculation	33,139,460	32,068,422	33,174,998	30,897,006
Diluted EPS	\$ 0.02	\$ 0.01	\$ 0.03	\$ 0.00

**5. INCOME TAXES:**

The Company files income tax returns in the U.S. federal jurisdiction and various states. There are currently no federal or state income tax examinations underway. Furthermore, the Company is no longer subject to U.S. federal income tax examinations by the Internal Revenue Service for tax years before 2005 and for state and local tax authorities for tax years before 2002. The Company does, however, have net operating losses generated in tax years 1997 and after, which remain open for examination.

The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, on January 1, 2007. The Company does not foresee the total amounts of unrecognized tax benefits significantly increasing within the next 12 months. Furthermore, no corresponding interest and penalties have been accrued as the Company is in a net operating loss position.

The Company provides for income taxes in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes ( SFAS 109 ). SFAS 109 requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial statement carrying amounts and the tax basis of the assets and liabilities. Where it is more likely than not that a tax benefit will not be realized, a valuation allowance is recorded to reduce the deferred tax asset to its realizable value.

A valuation allowance has been provided against the Company's net deferred tax assets as the Company believes that it is more likely than not that the net deferred tax assets will not be realized.

The effective tax rate for the six month period ended June 30, 2008 and for the year ended December 31, 2007 is 3.1 percent, and differs from statutory rates primarily due to changes in the valuation allowance.

Table of Contents**6. COMMON STOCK OPTIONS:**

There were no material changes to common stock options from those disclosed in the audited annual consolidated financial statements for the year ended December 31, 2007 except as follows:

On June 27, 2008, the Company issued 820,000 common stock options to officers, directors, and employees at a price of \$4.28 per share with a term of 5 years from the date issued (expiring June 26, 2013) and shall vest over five years pursuant to the Stock Option Plan.

The weighted average fair value of options granted on June 27, 2008, as calculated under the Black-Scholes pricing model is \$2.17. The fair value of each new issued option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions: risk-free, weighted-average interest rate of 3.5% based on the U.S. Treasury yield curve in effect at the time of grant, expected dividend yield of 0 percent, expected life of 5 years from the date of grant, and expected volatility of 65.68%.

On April 25, 2008, an officer and director exercised options to purchase 750,000 shares of common stock at an exercise price of \$0.50 per share. The options were granted on April 30, 1996 and had an expiration date of April 30, 2008.

The options outstanding as of June 30, 2008 have the following contractual lives:

<b>Number of Options Outstanding</b>	<b>Number of Options Exercisable</b>	<b>Exercise Prices</b>	<b>Weighted Average Remaining Contractual Life</b>
1,750,000	1,730,000	2.10	4.92
150,000	30,000	3.85	2.79
10,000	6,000	4.25	1.51
820,000		4.28	5.00
10,000	6,000	6.25	1.94
2,740,000	1,772,000		

The total intrinsic value of options outstanding was approximately \$3,366,500 and \$8,473,700 at June 30, 2008 and 2007, respectively. The intrinsic value for exercisable options was \$3,309,100 and \$7,762,500 at June 30, 2008 and 2007, respectively.

As of June 30, 2008, there are 1,772,000 options which are exercisable. The remaining 968,000 options will become exercisable over the next five years. The stock compensation expense related to the unvested awards is \$1,934,551.

**7. COMMON STOCK WARRANTS:**

There were no new warrants issued during the first six months of 2008.

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**8. COMMITMENTS AND CONTINGENCIES:**

There are no material changes to commitments and contingencies from those disclosed in the audited annual consolidated financial statements for the year ended December 31, 2007 except as follows:

South Dry Hollow Prospect, Lavaca County, Texas On February 26, 2008, the Company's subsidiary, South Texas GeoPetro LLC, entered into a participation agreement wherein it acquired a 15% non-operated working interest in the South Dry Hollow Prospect, which is located in Lavaca County, Texas. On February 25, 2008, the Company paid a \$150,000 prospect fee and advanced \$1.1 million to drill the Eichhorn #1 Well. The Eichhorn #1 Well was drilled to a depth of approximately 16,650 feet and is currently being evaluated for production.

**9. SUBSEQUENT EVENTS:**

On July 2, 2008, the Company issued 83,676 shares of our common stock pursuant to a cashless exercise of 175,125 common stock warrants.

Alaska Cook Inlet CMB Project: On July 31, 2008, the Company entered into a third amendment with Pioneer Oil Company (Pioneer). The amendment provides that the Company will advance to Pioneer the sum of \$1,168,093 on or before August 10, 2008, which represents the second and final payment for leases comprising 116,806 acres onshore in Cook Inlet, Alaska. The amendment further provides that the work program requiring \$2.5 million in expenditures by GeoPetro has been eliminated in its entirety.



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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 accompanying financial statements and related notes included elsewhere in this report. It contains forward looking statements that reflect our future plans, estimates, beliefs and expected performance. The forward looking statements are dependent upon events, risks and uncertainties that may be outside our control. Our actual results could differ materially from those discussed in these forward looking statements.*

*Factors that could cause or contribute to such differences include, but are not limited to, market prices for natural gas and oil, economic and competitive conditions, regulatory changes, estimates of proved reserves, potential failure to achieve production from development drilling projects, capital expenditures and other uncertainties, as well as those factors discussed below and elsewhere in this report, particularly in Risk Factors and Cautionary Notes Regarding Forward Looking Statements, all of which are difficult to predict and which expressly qualify all subsequent oral and written forward-looking statements attributable to us or persons acting on our behalf. In light of these risks, uncertainties and assumptions, the forward looking events discussed may not occur. We do not have any intention or obligation to update forward-looking statements included in this report after the date of this report, except as required by law.*

**Overview**

We are an oil and gas company in the business of exploring and developing oil and natural gas reserves on a worldwide basis. Since inception, we have conducted leasehold acquisition, exploration and drilling activities on our North American, Australian and Indonesian prospects. These projects currently encompass approximately 372,317 gross (158,401 net) acres, consisting of mineral leases, production sharing contracts and exploration permits that give us the right to explore for, develop and produce oil and natural gas. Most of these properties are in the exploration, appraisal or development drilling phase and have not begun to produce revenue from the sale of oil and natural gas. Excluding minor interest and dividend income, our only significant cash inflows until 2003 were the recovery of capital invested in projects through sale or other divestiture of interests in oil and gas prospects to industry partners.

Since 2003, substantially all of our revenue has been generated from natural gas sales derived from the Magness #1, the Fannin #1, and the Mitchell #1 wells in the Madisonville Field in East Texas under spot gas purchase contracts at market prices. Natural gas sales from the Madisonville Field are expected to account for substantially all of our revenues for 2008. We expect the majority of our capital expenditures in 2008 to be spent on the Madisonville Project.

Table of Contents**Results of Operations**

The financial information with respect to the six months ended June 30, 2008 and 2007 that is discussed below is unaudited. In the opinion of management, such information contains all adjustments, consisting only of normal recurring accruals, necessary for a fair presentation of the results for such periods. The results of operations for interim periods are not necessarily indicative of the results of operations for the full fiscal years.

	Six Months Ended	
	June 30, 2008 (unaudited)	June 30, 2007 (unaudited)
<b>Consolidated Statement of Operations:</b>		
<b>Revenues</b>	\$ 4,793,590	\$ 4,212,192
<b>Lease operating expense</b>	990,382	846,107
<b>General and administrative</b>	1,319,513	1,526,919
<b>Net profits expense</b>	488,929	428,588
<b>Impairment expense</b>	63,766	
<b>Depreciation and depletion expense</b>	982,735	1,229,870
<b>Earnings from operations</b>	948,265	180,708
<b>Net income</b>	980,838	56,164
<b>Net income attributable to common shareholders</b>	\$ 980,838	\$ 56,164

**Industry Overview for the six months ended June 30, 2008**

The first half year of 2008 saw strengthening natural gas prices. The Houston Ship Channel price, the index price prevailing in the locale of our Madisonville Project in Madison County, Texas, as quoted in Gas Daily as of June 30, 2008, was \$12.94 per Mcf versus \$6.81 per Mcf as of December 31, 2007. Higher natural gas prices this year and next reflect continued strong demand, high oil prices, and the need to replenish more stocks this year than last year, among other factors.

**Company Overview for the six months ended June 30, 2008**

Our net income after taxes for the six months ended June 30, 2008 was \$980,838. From our inception, through mid-2003, we only received nominal revenues from our oil and natural gas activities, while incurring substantial acquisition and exploration costs and overhead expenses which have resulted in an accumulated deficit through June 30, 2008 of \$11,029,951. Commencing in May 2003, we placed our Madisonville Project into production. Substantially all of our oil and natural gas sales for the six months ended June 30, 2008 were derived from our Madisonville Project, from three producing wells, the UMC Ruby Magness #1 well (the Magness Well), the Angela Farris Fannin #1 well (the Fannin Well), and the Mitchell #1 well (the Mitchell Well).

**Comparison of Results of Operations for the three months ended June 30, 2008 and 2007**

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During the three months ended June 30, 2008, we had oil and natural gas revenues of \$2,650,992. Our net production was 374,534 Mcf of natural gas at an average price of \$7.08 per Mcf. During the three months ended June 30, 2007, we had oil and natural gas revenues of \$2,388,850. Our net production for the three months ended June 30, 2007 was 583,486 Mcf at an average price of \$4.09 per Mcf. Revenues increased in the three months ended June 30, 2008 as compared to the prior year period due to higher natural gas prices. The 36% lower production volumes for the three months ended June 30, 2008 as compared to the same period of 2007 was due to the Magness #1 well shut-in during the workover. Natural gas prices were approximately 73% higher for the three months ended June 30, 2008 versus the same period in 2007.

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During the three months ended June 30, 2008, we incurred lease operating expense of \$646,559. Our average lifting cost for the 2008 period was \$1.73 per Mcf. During the three months ended June 30, 2007, we incurred lease operating expense of \$418,830. Our average lifting cost for the 2007 period was \$0.72 per Mcf. The average lifting cost per Mcf in 2008 was higher due to major workovers performed on the Magness well during that period.

During the three months ended June 30, 2008, we incurred net profits interest expense of \$260,868 associated with the Magness, the Fannin, and the Mitchell wells as compared to \$244,384 during the three months ended June 30, 2007. The 7% increase resulted from higher gas prices in the three months ended June 30, 2008 versus 2007. The net profit interest is 12.5% of the net operating profit from our Magness, Fannin, and Mitchell wells.

General and administrative ( **G&A** ) expenses for the three months ended June 30, 2008 were \$604,090 compared to \$767,563 for the three months ended June 30, 2007. This represents a \$163,473 or 21% decrease over the prior year period. The higher G&A expense incurred in 2007 was due primarily to costs associated with our initial SEC registration and American Stock Exchange listing.

The 2008 second quarter impairment expense was \$63,766 versus \$0 for the 2007 second quarter. The 2008 impairment expense was the remaining balance due to a dry hole drilled in 2007 in the Wildwood project in Canada. Under the full cost accounting, the impairment is evaluated based on each cost center on a country by country basis.

Depreciation and depletion expense for the three months ended June 30, 2008 was \$448,305 as compared to \$652,928 in the same period of 2007, which amounts primarily represent depletion of the oil and gas properties for the three months ended June 30, 2008 and 2007, respectively. The 31% decrease was due to lower net production in the three months period of 2008.

Income from operations totaled \$627,404 for the three months ended June 30, 2008 as compared to \$305,145 for the same period of 2007. The increase in the income from operations was due primarily to higher gas prices and lower expenses.

Other income for the three months ended June 30, 2008 and 2007 consisted of interest income in the amount of \$17,803 and \$28,196, respectively. The higher interest income in the three months ended June 30, 2007 was due primarily to interest received from a note receivable. The note was paid off on June 29, 2007.

During the three months ended June 30, 2008 and 2007, we incurred interest expense of \$0 and \$92,263, respectively. We had no outstanding debt during the second quarter of 2008 since all loans were paid in full in October 2007.

Net income before taxes for the three months ended June 30, 2008 was \$645,207 as compared to net income before taxes of \$241,078 for the three months ended June 30, 2007. The increase in net income during the three months ended June 30, 2008 was primarily due to higher gas prices and lower expenses.



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Income tax expense for the three months ended June 30, 2008 was \$8,495 compared to \$2,300 in the same period of 2007. The increased income tax expense was due to alternative minimum tax incurred in the second quarter of 2008.

**Comparison of Results of Operations for the six months ended June 30, 2008 and 2007**

During the six months ended June 30, 2008, we had oil and natural gas revenues of \$4,793,590, and our net production was 825,184 Mcf of natural gas at an average price of \$5.81 per Mcf. During the six months ended June 30, 2007, we had oil and natural gas revenues of \$4,212,192 and our net production was 1,108,338 Mcf at an average price of \$3.80 per Mcf. Revenues increased in the six months ended June 30, 2008 as compared to the prior year period due to higher natural gas prices. The 26% lower production volumes for the six months ended June 30, 2008 as compared to the same period of 2007 was due to shut-ins during the workover activity on the Company's wells. Natural gas prices were approximately 53% higher for the six months ended June 30, 2008 versus the same period in 2007.

During the six months ended June 30, 2008, we incurred lease operating expense of \$990,382. Our average lifting cost for the 2008 period was \$1.20 per Mcf. During the six months ended June 30, 2007, we incurred lease operating expense of \$846,107. Our average lifting cost for the 2007 period was \$0.76 per Mcf. The average lifting cost per Mcf in 2008 was higher due to major workovers performed on the Magness well during that period.

During the six months ended June 30, 2008, we incurred net profits interest expense of \$488,929 associated with the Magness, the Fannin, and the Mitchell wells as compared to \$428,588 during the six months ended June 30, 2007. The 14% increase resulted from higher gas prices in the six months ended June 30, 2008 versus 2007. The net profit interest is 12.5% of the net operating profit from our Magness, Fannin, and Mitchell wells.

General and administrative ( **G&A** ) expenses for the six months ended June 30, 2008 were \$1,319,513 compared to \$1,526,919 for the six months ended June 30, 2007. This represents a \$207,406 or 14% decrease over the prior year period. The higher G&A expense incurred in 2007 was due primarily to costs associated with our initial SEC registration and American Stock Exchange listing.

The 2008 six months ended June 30, the impairment expense was \$63,766 versus \$0 for the same period of 2007. The 2008 impairment expense was the remaining costs associated with a dry hole drilled in 2007 in the Wildwood project in Canada. Under the full cost accounting, the impairment is evaluated based on each cost center on a country by country basis.

Depreciation and depletion expense for the six months ended June 30, 2008 was \$982,735 as compared to \$1,229,870 in the same period of 2007, which amounts primarily represent depletion of the oil and gas properties for the six months ended June 30, 2008 and 2007, respectively. The 20% decrease was due to lower net production in the six months period of 2008.

Income from operations totaled \$948,265 for the six months ended June 30, 2008 as compared to income from operations of \$180,708 for the six months ended June 30, 2007. The increase in the income from operations was due primarily to higher gas prices and lower expenses.



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Other income for the six months ended June 30, 2008 and 2007 consisted of interest income in the amount of \$47,868 and \$56,201, respectively. The higher interest income in 2007 was due primarily to interest received from a note receivable. The note was paid off on June 29, 2007.

During the six months ended June 30, 2008 and 2007, we incurred interest expense of \$0 and \$178,445, respectively. We had no outstanding debt during the six months ended June 30, 2008 since all loans were paid in full in October 2007.

Net income before taxes for the six months ended June 30, 2008 was \$996,133 as compared to net income before taxes of \$58,464 for the six months ended June 30, 2007. The increase in net income during the six months ended June 30, 2008 was primarily due to higher gas price and lower expenses.

Income tax expense for the six months ended June 30, 2008 was \$15,295 compared to \$2,300 in the same period of 2007. The increased income tax expense was due to alternative minimum tax incurred in the first half year of 2008.

**Recent Developments**

In 2005 we secured a commitment from Madisonville Gas Processing, LP ( MGP ) to install and make operational additional treating facilities capable of treating 50 MMcf/d, which combined with the capacity of the current in-service treating facilities will represent a total designed treating capacity of 68 MMcf/d for the Madisonville treatment plant. In October 2007, MGP informed us that they had partially completed construction of the additional treating facilities. Subsequently in November 2007, MGP commenced phase-in of the additional treating capacity reaching a temporary peak inlet volume of 21 mmcf/d out of the total contracted 50 mmcf/d design capacity at such facilities. However, operations at the additional treating facilities were suspended by MGP in December 2007 in order to make the necessary modifications to effectively deal with the presence of diamondoids in the gas stream produced from the Rodessa Formation. A diamondoid is a rare, naturally occurring compound that can segregate out of the gas stream upon a decrease in temperature and pressure and as such, could cause operational problems for the nitrogen rejection portion of the additional treating facilities. MGP previously obtained a detail laboratory composition analysis of the diamondoids, conducted a pilot test of a diamondoid removal process at the field level and is currently designing modifications to the operating system. MGP indicates that removal of the diamondoids will require flowing the natural gas stream through a hydrocarbon contactor after the gas stream has had the hydrogen sulfide and carbon dioxide removed. Through this contactor process, the hydrocarbons will absorb the diamondoids from the gas stream prior to entry into the nitrogen removal tower. In the meantime, the existing, in service portion of the plant continues to treat inlet gas.

On April 25, 2008, an officer and director exercised options to purchase 750,000 shares of common stock at an exercise price of \$0.50 per share. The options were granted on April 30, 1996 and had an expiration date of April 30, 2008.

On February 26, 2008, the Company's subsidiary, South Texas GeoPetro LLC, entered into a participation agreement wherein it acquired a 15% non-operated working interest in the South Dry Hollow Prospect, which is located in Lavaca County, Texas. On February 25, 2008, the Company paid a \$150,000 prospect fee and advanced \$1.1 million to drill the Eichhorn #1 Well. The Eichhorn #1 Well was drilled to a depth of approximately 16,650 feet and is currently being evaluated for production.



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On July 31, 2008, the Company entered into a third amendment with Pioneer Oil Company ( Pioneer ). The amendment provides that the Company will advance to Pioneer the sum of \$1,168,093 on or before August 10, 2008, which represents the second and final payment for leases comprising 116,806 acres onshore in Cook Inlet, Alaska. The amendment further provides that the work program requiring \$2.5 million in expenditures by GeoPetro has been eliminated in its entirety.

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**Liquidity and Capital Resources**

We had a working capital surplus of \$2,718,593 at June 30, 2008 versus \$3,361,853 at December 31, 2007. Our working capital decreased during six months ended June 30, 2008 due primarily to our participation in the drilling of a well in South Texas.

We have historically financed our business activities principally through issuances of common shares, promissory notes and common share purchase warrants in private placements and an initial public offering. However, during the six months ended June 30, 2008, we had minor financing activities. These financings are summarized as follows: