

Laredo Petroleum, Inc.
Form 10-Q
November 06, 2014

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

Form 10-Q

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

For the quarterly period ended September 30, 2014

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: 001-35380

Laredo Petroleum, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware

(State or Other Jurisdiction of
Incorporation or Organization)

15 W. Sixth Street, Suite 900

Tulsa, Oklahoma

(Address of Principal Executive Offices)

(918) 513-4570

(Registrant's Telephone Number, Including Area Code)

45-3007926

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

74119

(Zip 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

Number of shares of registrant's common stock outstanding as of November 3, 2014: 143,685,200

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

Various statements contained in or incorporated by reference into this Quarterly Report on Form 10-Q (this "Quarterly Report") are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements include statements, projections and estimates concerning our operations, performance, business strategy, oil and natural gas reserves, drilling program capital expenditures, liquidity and capital resources, the timing and success of specific projects, outcomes and effects of litigation, claims and disputes, derivative activities and potential financing. Forward-looking statements are generally accompanied by words such as "estimate," "project," "predict," "believe," "expect," "anticipate," "potential," "could," "may," "will," "foresee," "plan," "goal," "should," "intend," "pursue," "target," "continue," "suggest" or the negative thereof or other variations thereof or other words that convey the uncertainty of future events or outcomes. Forward-looking statements are not guarantees of performance. These statements are based on certain assumptions and analyses made by us in light of our experience and our perception of historical trends, current conditions and expected future developments as well as other factors we believe are appropriate under the circumstances. Among the factors that significantly impact our business and could impact our business in the future are:

- volatility of oil and natural gas prices;
- changes in domestic and global demand for oil and natural gas;
- the continuation of restrictions on the export of domestic oil and its potential to cause weakness in domestic pricing;
- the possible introduction of regulations that prohibit or restrict our ability to apply hydraulic fracturing to our oil and natural gas wells and to access and dispose of water used in these operations;
- the ongoing instability and uncertainty in the U.S. and international financial and consumer markets that could adversely affect the liquidity available to us and our customers and could adversely affect the demand for commodities, including oil and natural gas;
- the possible introduction of regulations that prohibit or restrict our ability to drill new allocation wells;
- discovery, estimation, development and replacement of oil and natural gas reserves, including our expectations that estimates of our proved reserves will increase;
- uncertainties about the estimates of our oil and natural gas reserves;
- competition in the oil and natural gas industry;
- the availability and costs of drilling and production equipment, labor, and oil and natural gas processing and other services;
- drilling and operating risks, including risks related to hydraulic fracturing activities;
- risks related to the geographic concentration of our assets;
- the availability of sufficient pipeline and transportation facilities and gathering and processing capacity;
- changes in the regulatory environment or changes in international, legal, political, administrative or economic conditions;
- our ability to comply with federal, state and local regulatory requirements;
- our ability to execute our strategies, including but not limited to our hedging strategies;
- our ability to recruit and retain the qualified personnel necessary to operate our business;
- evolving industry standards and adverse changes in global economic, political and other conditions;
- restrictions contained in our debt agreements, including our Senior Secured Credit Facility (as defined below) and the indentures governing our senior unsecured notes, as well as debt that could be incurred in the future;
- our ability to access additional borrowing capacity under our Senior Secured Credit Facility or other means of providing liquidity; and
- our ability to generate sufficient cash to service our indebtedness and to generate future profits.

These forward-looking statements involve a number of risks and uncertainties that could cause actual results to differ materially from those suggested by the forward-looking statements. Forward-looking statements should, therefore, be

considered in light of various factors, including those set forth under "Part I, Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations", "Part II, Item 1A. Risk Factors" and elsewhere in this Quarterly Report, under "Part I, Item 1A. Risk Factors" and "Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 (the "2013 Annual Report"), and those set forth from time to time in our other filings with the Securities and Exchange Commission (the "SEC"). These documents are available through our website or through the SEC's Electronic Data Gathering and Analysis Retrieval system at <http://www.sec.gov>. In light of such risks and uncertainties, we caution you not to place undue reliance on these forward-looking statements. These forward-looking statements speak only as of the date of this Quarterly Report, or if earlier, as of the date they were made. We do not intend to, and disclaim any obligation to, update or revise any forward-looking statements unless required by securities law.

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PART I

Item 1. Consolidated Financial Statements (Unaudited)

Laredo Petroleum, Inc.

Consolidated balance sheets

(in thousands, except share data)

(Unaudited)

	September 30, 2014	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	\$55,760	\$198,153
Accounts receivable, net	103,767	77,318
Derivatives	11,520	15,806
Deferred income taxes	1,255	3,634
Other current assets	18,159	12,698
Total current assets	190,461	307,609
Property and equipment:		
Oil and natural gas properties, full cost method:		
Proved properties	4,021,449	3,276,578
Unproved properties not being amortized	427,132	208,085
Midstream service assets	102,758	51,704
Other fixed assets	43,834	32,832
Total property and equipment	4,595,173	3,569,199
Less accumulated depletion, depreciation, amortization and impairment	(1,530,322)	(1,364,875)
Net property and equipment	3,064,851	2,204,324
Derivatives	5,327	79,726
Deferred loan costs, net	29,777	25,933
Investment in equity method investee	40,810	5,913
Other assets, net	1,683	255
Total assets	\$3,332,909	\$2,623,760
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$55,458	\$16,002
Accrued payable - affiliates	2,670	3,489
Undistributed revenue and royalties	49,229	35,124
Accrued capital expenditures	140,273	116,328
Derivatives	4,454	10,795
Other current liabilities	66,090	72,231
Total current liabilities	318,174	253,969
Long-term debt	1,576,358	1,051,538
Derivatives	1,695	2,680
Deferred income taxes	49,425	16,293
Asset retirement obligations	26,432	21,478
Other noncurrent liabilities	6,130	5,546
Total liabilities	1,978,214	1,351,504
Commitments and contingencies		
Stockholders' equity:		

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Preferred stock, \$0.01 par value, 50,000,000 shares authorized and zero issued at September 30, 2014 and December 31, 2013	—	—
Common stock, \$0.01 par value, 450,000,000 shares authorized, and 143,714,899 and 142,671,436 issued, at September 30, 2014 and December 31, 2013, respectively	1,437	1,427
Additional paid-in capital	1,301,943	1,283,809
Retained earnings (accumulated deficit)	51,315	(12,980)
Total stockholders' equity	1,354,695	1,272,256
Total liabilities and stockholders' equity	\$3,332,909	\$2,623,760

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

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Laredo Petroleum, Inc.

Consolidated statements of operations

(in thousands, except per share data)

(Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Revenues:				
Oil and natural gas sales	\$199,490	\$170,840	\$555,576	\$511,513
Midstream service revenue	751	—	1,019	328
Total revenues	200,241	170,840	556,595	511,841
Costs and expenses:				
Lease operating expenses	25,165	19,565	67,129	64,192
Midstream service expense	1,225	1,090	3,596	2,569
Production and ad valorem taxes	12,550	11,723	38,160	32,890
Natural gas volume commitment - affiliates	675	305	1,779	444
General and administrative	27,078	24,405	84,284	64,534
Accretion of asset retirement obligations	442	350	1,279	1,154
Depletion, depreciation and amortization	63,942	55,982	166,605	186,719
Total costs and expenses	131,077	113,420	362,832	352,502
Operating income	69,164	57,420	193,763	159,339
Non-operating income (expense):				
Gain (loss) on derivatives:				
Commodity derivatives, net	92,790	(9,830)	(1,447)	(2,709)
Interest rate derivatives, net	—	(8)	—	(23)
Income (loss) from equity method investee	(61)	48	(86)	(65)
Interest expense	(30,549)	(24,929)	(90,192)	(76,221)
Interest and other income	33	59	310	86
Write-off of deferred loan costs	—	(1,502)	(124)	(1,502)
Gain (loss) on disposal of assets, net	(2,192)	607	(2,418)	548
Non-operating income (expense), net	60,021	(35,555)	(93,957)	(79,886)
Income from continuing operations before income taxes	129,185	21,865	99,806	79,453
Income tax expense:				
Deferred	(45,778)	(10,048)	(35,511)	(31,205)
Total income tax expense	(45,778)	(10,048)	(35,511)	(31,205)
Income from continuing operations	83,407	11,817	64,295	48,248
Income from discontinued operations, net of tax	—	726	—	1,516
Net income	\$83,407	\$12,543	\$64,295	\$49,764
Net income per common share:				
Basic:				
Income from continuing operations	\$0.59	\$0.09	\$0.46	\$0.37
Income from discontinued operations, net of tax	—	—	—	0.01
Net income per share	\$0.59	\$0.09	\$0.46	\$0.38
Diluted:				
Income from continuing operations	\$0.58	\$0.09	\$0.45	\$0.37
Income from discontinued operations, net of tax	—	—	—	0.01
Net income per share	\$0.58	\$0.09	\$0.45	\$0.38
Weighted-average common shares outstanding:				
Basic	141,413	134,461	141,261	129,701

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Diluted	143,813	136,460	143,583	131,589
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The accompanying notes are an integral part of these unaudited consolidated financial statements.

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Laredo Petroleum, Inc.
 Consolidated statement of stockholders' equity
 (in thousands)
 (Unaudited)

	Common Stock		Additional paid-in capital	Treasury Stock (at cost)		Retained earnings (accumulated deficit)	Total
	Shares	Amount		Shares	Amount		
Balance, December 31, 2013	142,671	\$1,427	\$1,283,809	—	\$—	\$ (12,980)	\$1,272,256
Restricted stock awards	1,209	12	(12)	—	—	—	—
Restricted stock forfeitures	(105)	(1)	1	—	—	—	—
Vested restricted stock exchanged for tax withholding	—	—	—	155	(4,075)	—	(4,075)
Retirement of treasury stock	(155)	(2)	(4,073)	(155)	4,075	—	—
Exercise of employee stock options	95	1	1,884	—	—	—	1,885
Stock-based compensation	—	—	20,334	—	—	—	20,334
Net income	—	—	—	—	—	64,295	64,295
Balance, September 30, 2014	143,715	\$1,437	\$1,301,943	—	\$—	\$ 51,315	\$1,354,695

The accompanying notes are an integral part of this unaudited consolidated financial statement.

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Laredo Petroleum, Inc.

Consolidated statements of cash flows

(in thousands)

(Unaudited)

	Nine months ended September 30,	
	2014	2013
Cash flows from operating activities:		
Net income	\$64,295	\$49,764
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income tax expense	35,511	31,970
Depletion, depreciation and amortization	166,605	187,346
Bad debt expense	—	653
Non-cash stock-based compensation, net of amount capitalized	16,919	13,556
Accretion of asset retirement obligations	1,279	1,154
Mark-to-market on derivatives:		
Loss on derivatives, net	1,447	2,732
Cash settlements (paid) received for matured derivatives, net	(1,320)	) 588
Cash settlements received for early terminations of derivatives, net	76,660	5,366
Change in net present value of deferred premiums paid for derivatives	170	384
Cash premiums paid for derivatives	(5,599)	) (7,920)
Amortization of deferred loan costs	3,823	3,905
Write-off of deferred loan costs	124	1,502
Other	2,734	(662)
(Increase) decrease in accounts receivable	(26,449)	) 5,873
Increase in other assets	(8,656)	) (1,383)
Increase (decrease) in accounts payable	39,456	(17,724)
Increase (decrease) in undistributed revenues and royalties	14,105	(5,780)
Decrease in other accrued liabilities	(7,908)	) (1,406)
Increase in other noncurrent liabilities	2,373	570
Increase in fair value of performance unit awards	767	4,950
Net cash provided by operating activities	376,336	275,438
Cash flows from investing activities:		
Capital expenditures:		
Acquisition of oil and natural gas properties	(6,493)	) (33,710)
Acquisition of mineral interests	(7,305)) —
Oil and natural gas properties	(925,121)	) (538,395)
Midstream service assets	(45,263)	) (15,394)
Other fixed assets	(13,612)	) (13,874)
Investment in equity method investee	(37,581)	) (3,287)
Proceeds from dispositions of capital assets, net of costs	1,627	429,702
Net cash used in investing activities	(1,033,748)	) (174,958)
Cash flows from financing activities:		
Borrowings on Senior Secured Credit Facility	75,000	230,000
Payments on Senior Secured Credit Facility	—	(395,000)
Issuance of January 2022 Notes	450,000	—
Proceeds from issuance of common stock, net of offering costs	—	298,104
Purchase of treasury stock	(4,075)	) (1,478)
Proceeds from exercise of employee stock options	1,885	654
Payments for loan costs	(7,791)) (714)

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Net cash provided by financing activities	515,019	131,566
Net (decrease) increase in cash and cash equivalents	(142,393) 232,046
Cash and cash equivalents, beginning of period	198,153	33,224
Cash and cash equivalents, end of period	\$55,760	\$265,270

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

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Laredo Petroleum, Inc.
Condensed notes to the consolidated financial statements
(Unaudited)

A—Organization

Laredo Petroleum, Inc. ("Laredo" and formerly known as Laredo Petroleum Holdings, Inc.), together with its subsidiary, Laredo Midstream Services, LLC ("Laredo Midstream"), is an independent energy company focused on the acquisition, exploration and development of oil and natural gas properties primarily in the Permian Basin in West Texas. In these notes, the "Company," (i) when used in the present tense, prospectively or as of December 31, 2013, refers to Laredo and Laredo Midstream collectively and (ii) when used for historical periods prior to December 31, 2013, refers to Laredo and its subsidiaries, collectively. All amounts, dollars and percentages presented in these unaudited consolidated financial statements and the related notes are rounded and therefore approximate.

B—Basis of presentation and significant accounting policies

1. Basis of presentation

The accompanying unaudited consolidated financial statements were derived from the historical accounting records of the Company and reflect the historical financial position, results of operations and cash flows for the periods described herein. The Company uses the equity method of accounting to record its net interests when the Company holds 20% to 50% of the voting rights and/or has the ability to exercise significant influence but does not control the entity. Under the equity method, the Company's proportionate share of the investee's net income (loss) is included in the unaudited consolidated statements of operations. See Note L for additional discussion of the Company's equity method investment. The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). All material intercompany transactions and account balances have been eliminated in the consolidation of accounts. The Company reports as one business segment, which explores for, develops and produces oil and natural gas. Unless otherwise indicated, the information in these notes relate to the Company's continuing operations.

The accompanying consolidated financial statements have not been audited by the Company's independent registered public accounting firm, except that the consolidated balance sheet as of December 31, 2013 is derived from audited consolidated financial statements. In the opinion of management, the accompanying unaudited consolidated financial statements reflect all necessary adjustments to present fairly the Company's financial position as of September 30, 2014, results of operations for the three and nine months ended September 30, 2014 and 2013 and cash flows for the nine months ended September 30, 2014 and 2013.

Certain disclosures have been condensed or omitted from these unaudited consolidated financial statements. Accordingly, these unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in Laredo's Annual Report on Form 10-K for the year ended December 31, 2013 (the "2013 Annual Report").

2. Use of estimates in the preparation of interim unaudited consolidated financial statements

The preparation of the accompanying unaudited consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions about future events. These estimates and the underlying assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although management believes these estimates are reasonable, actual results could differ. The interim results reflected in the unaudited consolidated financial statements are not necessarily indicative of the results that may be expected for other interim periods or for the full year.

Significant estimates include, but are not limited to, (i) estimates of the Company's reserves of oil and natural gas, (ii) future cash flows from oil and natural gas properties, (iii) depletion, depreciation and amortization, (iv) asset retirement obligations, (v) stock-based compensation, (vi) deferred income taxes, (vii) fair value of assets acquired and liabilities assumed in an acquisition and (viii) fair values of commodity derivatives, interest rate derivatives, commodity deferred premiums and performance unit awards. As fair value is a market-based measurement, it is determined based on the assumptions that market participants would use. These estimates and assumptions are based on management's best judgment. Management evaluates its estimates and assumptions on an ongoing basis using historical experience and other factors, including the current economic environment. Such estimates and assumptions

are adjusted when facts and circumstances dictate. Illiquid credit markets and volatile equity and energy markets have combined to increase the uncertainty inherent in such estimates and assumptions. Management believes its estimates and assumptions to be reasonable under the circumstances. As future events and their effects cannot be determined with precision, actual values and results could differ from these estimates. Any changes in estimates resulting from future changes in the economic environment will be reflected in the financial statements in future periods.

Laredo Petroleum, Inc.
Condensed notes to the consolidated financial statements
(Unaudited)

3. Reclassifications

Certain amounts in the accompanying unaudited consolidated financial statements have been reclassified to conform to the 2014 presentation. These reclassifications had no impact to previously reported net income, total stockholders' equity or cash flows.

4. Treasury stock

The Company acquires treasury stock, which is recorded at cost, to satisfy tax withholding obligations for Laredo's employees that arise upon the lapse of restrictions on restricted stock. Upon acquisition, this treasury stock is retired.

5. Accounts receivable

The Company sells oil and natural gas to various customers and participates with other parties in the drilling, completion and operation of oil and natural gas wells. Joint interest and oil and natural gas sales receivables related to these operations are generally unsecured. Accounts receivable for joint interest billings are recorded as amounts billed to customers less an allowance for doubtful accounts.

Amounts are considered past due after 30 days. The Company determines joint interest operations accounts receivable allowances based on management's assessment of the creditworthiness of the joint interest owners. Additionally, as the operator of the majority of its wells, the Company has the ability to realize the receivables through netting of anticipated future production revenues. The Company maintains an allowance for doubtful accounts for estimated losses inherent in its accounts receivable portfolio. In establishing the required allowance, management considers historical losses, current receivables aging, and existing industry and economic data. The Company reviews its allowance for doubtful accounts quarterly. Past due balances greater than 90 days and over a specified amount are reviewed individually for collectability. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is remote.

Accounts receivable consist of the following components for the periods presented:

(in thousands)	September 30, 2014	December 31, 2013
Oil and natural gas sales	\$72,449	\$57,647
Joint operations, net ⁽¹⁾	27,164	16,629
Other	4,154	3,042
Total	\$103,767	\$77,318

(1) Accounts receivable for joint operations are presented net of an allowance for doubtful accounts of \$0.7 million as of September 30, 2014 and December 31, 2013.

6. Derivatives

The Company uses derivatives to reduce its exposure to fluctuations in the prices of oil and natural gas. By removing a significant portion of the price volatility associated with future production, the Company expects to mitigate, but not eliminate, the potential effects of variability in cash flows from operations due to fluctuations in commodity prices. These transactions are primarily in the form of collars, swaps, puts and basis swaps. In addition, in prior periods the Company entered into derivative contracts in the form of interest rate derivatives to minimize the effects of fluctuations in interest rates.

Derivatives are recorded at fair value and are included on the unaudited consolidated balance sheets as assets or liabilities. The Company nets the fair value of derivatives by counterparty in the accompanying unaudited consolidated balance sheets where the right of offset exists. The Company determines the fair value of its derivatives by utilizing pricing models for substantially similar instruments. Inputs to the pricing models include publicly available prices and forward price curves generated from a compilation of data gathered from third parties.

The Company's derivatives were not designated as hedges for accounting purposes for any of the periods presented. Accordingly, the changes in fair value are recognized in the unaudited consolidated statements of operations in the period of change. Gains and losses on derivatives are included in cash flows from operating activities (see Note G).

Laredo Petroleum, Inc.
 Condensed notes to the consolidated financial statements
 (Unaudited)

7. Property and equipment

The following table sets forth the Company's property and equipment for the periods presented:

(in thousands)	September 30, 2014	December 31, 2013
Proved oil and natural gas properties	\$4,021,449	\$3,276,578
Less accumulated depletion and impairment	(1,509,417	) (1,349,315
Proved oil and natural gas properties, net	2,512,032	1,927,263
Unproved properties not being amortized ⁽¹⁾	427,132	208,085
Midstream service assets	102,758	51,704
Less accumulated depreciation	(7,142	) (4,404
Midstream service assets, net	95,616	47,300
Other fixed assets	43,834	32,832
Less accumulated depreciation and amortization	(13,763	) (11,156
Other fixed assets, net	30,071	21,676
Total property and equipment, net	\$3,064,851	\$2,204,324

(1) The Company acquired significant leasehold interests during the three months ended September 30, 2014. For the three months ended September 30, 2014 and 2013, depletion expense was \$20.25 per barrel of oil equivalent ("BOE") sold and \$20.83 per BOE sold, respectively. For the nine months ended September 30, 2014 and 2013, depletion expense was \$19.83 per BOE sold and \$20.36 per BOE sold, respectively.

8. Deferred loan costs

Loan origination fees, which are stated at cost, net of amortization, are amortized over the life of the respective debt agreements utilizing the effective interest and straight-line methods. The Company capitalized \$7.8 million of deferred loan costs during the nine months ended September 30, 2014 mainly as a result of the issuance of the January 2022 Notes (as defined below). The Company capitalized \$0.7 million of deferred loan costs during the nine months ended September 30, 2013. The Company had total deferred loan costs of \$29.8 million and \$25.9 million, net of accumulated amortization of \$18.1 million and \$14.2 million, as of September 30, 2014 and December 31, 2013, respectively.

As a result of changes in the borrowing base of the Senior Secured Credit Facility due to the issuance of the January 2022 Notes, the Company wrote-off \$0.1 million in deferred loan costs during the nine months ended September 30, 2014. During the nine months ended September 30, 2013, \$1.5 million of deferred loan costs were written-off as a result of changes in the borrowing base of the Senior Secured Credit Facility due to the Anadarko Basin Sale. See Note D.5 and C.3 for definition of and information regarding the Senior Secured Credit Facility and the Anadarko Basin Sale, respectively.

Future amortization expense of deferred loan costs as of September 30, 2014 is as follows:

(in thousands)	
Remaining 2014	\$1,316
2015	5,295
2016	5,361
2017	5,432
2018	5,222
Thereafter	7,151
Total	\$29,777

Laredo Petroleum, Inc.
 Condensed notes to the consolidated financial statements
 (Unaudited)

9. Other current assets and liabilities

Other current assets consist of the following components for the periods presented:

(in thousands)	September 30, 2014	December 31, 2013
Materials and supplies inventory	\$ 10,787	\$ 9,633
Prepaid expenses	7,372	3,065
Total other current assets	\$ 18,159	\$ 12,698

Other current liabilities consist of the following components for the periods presented:

(in thousands)	September 30, 2014	December 31, 2013
Accrued interest payable	\$ 27,525	\$ 25,885
Accrued compensation and benefits	14,444	16,711
Lease operating expense payable	11,263	10,637
Asset retirement obligations	838	265
Other accrued liabilities	12,020	18,733
Total other current liabilities	\$ 66,090	\$ 72,231

10. Asset retirement obligations

Asset retirement obligations associated with the retirement of tangible long-lived assets are recognized as a liability in the period in which they are incurred and become determinable. The associated asset retirement costs are part of the carrying amount of the long-lived asset. Subsequently, the asset retirement cost included in the carrying amount of the related long-lived asset is charged to expense through depletion, or for midstream asset retirement cost through depreciation, of the associated asset. Changes in the liability due to the passage of time are recognized as an increase in the carrying amount of the liability and as corresponding accretion expense.

The fair value of additions to the asset retirement obligation liability is measured using valuation techniques consistent with the income approach, which converts future cash flows into a single discounted amount. Significant inputs to the valuation include: (i) estimated plug and abandonment cost per well based on Company experience, (ii) estimated remaining life per well based on the reserve life per well, (iii) estimated remaining life of midstream assets, (iv) estimated removal and/or remediation costs for midstream assets, (v) future inflation factors and (vi) the Company's average credit adjusted risk-free rate. Inherent in the fair value calculation of asset retirement obligations are numerous assumptions and judgments including, in addition to those noted above, the ultimate settlement of these amounts, the ultimate timing of such settlement and changes in legal, regulatory, environmental and political environments. To the extent future revisions to these assumptions impact the fair value of the existing asset retirement obligation liability, a corresponding adjustment will be made to the asset balance.

The Company is obligated by contractual and regulatory requirements to remove certain pipeline and gas gathering assets and perform other remediation of the sites where such pipeline and gas gathering assets are located upon the retirement of those assets. However, the fair value of the asset retirement obligation cannot currently be reasonably estimated because the settlement dates are indeterminate. The Company will record an asset retirement obligation for pipeline and gas gathering assets in the periods in which settlement dates become reasonably determinable.

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The following reconciles the Company's asset retirement obligation liability for continuing and discontinued operations for the periods presented:

(in thousands)	Nine months ended September 30, 2014	Year ended December 31, 2013
Liability at beginning of period	\$21,743	\$21,505
Liabilities added due to acquisitions, drilling, midstream asset construction and other	4,665	2,709
Accretion expense	1,279	1,475
Liabilities settled upon plugging and abandonment	(519	) (226
Liabilities removed due to Anadarko Basin Sale	—	(7,801
Revision of estimates	102	4,081
Liability at end of period	\$27,270	\$21,743

11. Fair value measurements

The carrying amounts reported in the unaudited consolidated balance sheets for cash and cash equivalents, accounts receivable, prepaid expenses, accounts payable, undistributed revenue and royalties and other accrued assets and liabilities approximate their fair values. See Note D for fair value disclosures related to the Company's debt obligations. The Company carries its derivatives at fair value. See Note G and Note H for details regarding the fair value of the Company's derivatives.

12. Compensation awards

Stock-based compensation expense is recognized in "General and administrative" in the Company's unaudited consolidated statements of operations over the awards' vesting periods and is based on their grant date fair value. The Company utilizes the closing stock price on the date of grant, less an expected forfeiture rate, to determine the fair value of service vesting restricted stock awards and a Black-Scholes pricing model to determine the fair values of service vesting restricted stock option awards. The Company utilizes a Monte Carlo simulation prepared by an independent third party to determine the fair values of the performance share awards and performance unit awards. On January 1, 2014, the Company began capitalizing a portion of stock-based compensation for employees who are directly involved in the acquisition and exploration of its oil and gas properties into the full-cost pool. Capitalized stock-based compensation is included as an addition to "Oil and natural gas properties" in the unaudited consolidated balance sheets. See Note E for further discussion regarding the restricted stock awards, restricted stock option awards, performance share awards and performance unit awards.

13. Environmental

The Company is subject to extensive federal, state and local environmental laws and regulations. These laws, among other things, regulate the discharge of materials into the environment and may require the Company to remove or mitigate the environmental effects of the disposal or release of petroleum or chemical substances at various sites. All environmental expenditures, including expenditures that relate to an existing condition caused by past operations and that have no future economic benefits, are expensed in the period in which they occur. Liabilities for expenditures of a non-capital nature are recorded when environmental assessment or remediation is probable and the costs can be reasonably estimated. Such liabilities are generally undiscounted unless the timing of cash payments is fixed and readily determinable. Management believes no materially significant liabilities of this nature existed as of September 30, 2014 or December 31, 2013.

14. Supplemental cash flow disclosure information and non-cash investing and financing information

The following table summarizes the supplemental disclosure of cash flow information for the periods presented:

(in thousands)	Nine months ended September 30, 2014	2013
Cash paid for interest, net of \$51 and \$255 of capitalized interest, respectively	\$85,041	\$74,932

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The following presents the supplemental disclosure of non-cash investing and financing information for the periods presented:

(in thousands)	Nine months ended September 30,	
	2014	2013
Change in accrued capital expenditures	\$23,945	\$(41,001)
Capitalized asset retirement cost	\$4,767	\$1,978
Capitalized stock-based compensation	\$3,415	\$—
Equity issued in connection with acquisition	\$—	\$3,029

C—Acquisitions and divestiture

1. 2014 acquisition of leasehold interests

During the three months ended September 30, 2014, the Company completed a material acquisition of leasehold interests in the Midland Basin, primarily within the Company's core development area. The acquisition was accounted for as an acquisition of assets.

2. 2014 acquisition of mineral interests

On February 25, 2014, the Company completed the acquisition of the mineral interests underlying 278 net acres in Glasscock County, Texas in the Permian Basin for \$7.3 million. These mineral interests entitle the Company to receive royalty interests on all production from this acreage with no additional future capital or operating expenses required. As such, the acquisition was accounted for as an acquisition of assets.

3. 2014 acquisitions of proved and unproved oil and natural gas properties

The Company accounts for acquisitions of proved and unproved oil and natural gas properties under the acquisition method of accounting. Accordingly, the Company conducts assessments of net assets acquired and recognizes amounts for identifiable assets acquired and liabilities assumed at the estimated acquisition date fair values, while transaction and integration costs associated with the acquisitions are expensed as incurred.

The Company makes various assumptions in estimating the fair values of assets acquired and liabilities assumed. The most significant assumptions relate to the estimated fair values of proved and unproved oil and natural gas properties. The fair values of these properties are measured using valuation techniques that convert future cash flows to a single discounted amount. Significant inputs to the valuation include estimates of: (i) reserves, (ii) future operating and development costs, (iii) future commodity prices and (iv) a market-based weighted average cost of capital rate. The market-based weighted average cost of capital rate is subject to additional project-specific risk factors. To compensate for the inherent risk of estimating the value of the unproved properties, the discounted future net revenues of probable and possible reserves are reduced by additional risk-weighting factors.

On June 11, 2014, the Company completed the acquisition of proved and unproved oil and natural gas properties, totaling 460 net acres, located in Reagan County, Texas for \$4.7 million, net of closing adjustments. On June 23, 2014, the Company completed the acquisition of proved and unproved oil and natural gas properties, totaling 24 net acres, located in Glasscock County, Texas for \$1.8 million. The results of operations prior to June 2014 do not include results from these acquisitions.

4. 2013 divestiture of Anadarko assets

On August 1, 2013, the Company completed the sale of its oil and natural gas properties, associated pipeline assets and various other related property and equipment in the Anadarko Granite Wash, Central Texas Panhandle and the Eastern Anadarko Basin (the "Anadarko Basin Sale") to certain affiliates of EnerVest, Ltd. (collectively, "EnerVest") and certain other third parties in connection with the exercise of such third parties' preferential rights associated with the oil and natural gas assets. The purchase price consisted of \$400.0 million from EnerVest and \$38.0 million from the third parties. \$388.0 million of the purchase price, excluding closing adjustments, was allocated to oil and natural gas properties pursuant to the rules governing full cost accounting. After transaction costs and adjustments at closing reflecting an economic effective date of April 1, 2013, the net proceeds were \$428.3 million, net of working capital adjustments.

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Effective at closing, the operations and cash flows of these properties were eliminated from the ongoing operations of the Company and the Company does not have continuing involvement in the operations of these properties. The results of

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operations of the oil and natural gas properties that are a component of the Anadarko Basin Sale are not presented as discontinued operations pursuant to the rules governing full cost accounting for oil and natural gas properties. The following table presents revenues and operating expenses of the oil and natural gas properties that are a component of the Anadarko Basin Sale included in the accompanying unaudited consolidated statements of operations for the periods presented:

(in thousands)	Three months ended September 30, 2013	Nine months ended September 30, 2013
Revenues	\$11,429	\$61,166
Expenses ⁽¹⁾	9,283	50,120

⁽¹⁾ Expenses include lease operating expense, production and ad valorem tax expense, accretion expense and depletion, depreciation and amortization expense.

For the three and nine months ended September 30, 2013, the results of operations of the associated pipeline assets and various other related property and equipment ("Pipeline Assets") are presented as results of discontinued operations, net of tax in these unaudited consolidated financial statements. As a result of the sale of the Pipeline Assets, a gain of \$3.2 million was recognized in the consolidated statements of operations for the three and nine months ended September 30, 2013 in the line item "Gain (loss) on disposal of assets, net."

The following represents operating results from discontinued operations for the periods presented:

(in thousands)	Three months ended September 30, 2013	Nine months ended September 30, 2013
Revenues:		
Midstream service revenue	\$761	\$4,071
Total revenues from discontinued operations	761	4,071
Cost and expenses:		
Midstream service expense, net	(286	) 1,163
Depletion, depreciation and amortization	—	627
Total costs and expenses from discontinued operations	(286	) 1,790
Income from discontinued operations before income tax	1,047	2,281
Income tax expense	(321	) (765
Income from discontinued operations	\$726	\$1,516

D—Debt

1. Interest expense

The following amounts have been incurred and charged to interest expense for the periods presented:

(in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Cash payments for interest	\$38,952	\$26,627	\$85,092	\$75,187
Amortization of deferred loan costs and other adjustments	1,188	2,736	3,511	5,360
Change in accrued interest	(9,540	) (4,391	) 1,640	(4,071
Interest costs incurred	30,600	24,972	90,243	76,476
Less capitalized interest	(51) (43) (51) (255
Total interest expense	\$30,549	\$24,929	\$90,192	\$76,221

2. January 2022 Notes

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On January 23, 2014, the Company completed an offering of \$450.0 million in aggregate principal amount of 5 5/8% senior unsecured notes due 2022 (the "January 2022 Notes"), and entered into an Indenture (the "Indenture") among Laredo, Laredo Midstream as guarantor and Wells Fargo Bank, National Association, as trustee. The January 2022 Notes will mature on January 15, 2022 with interest accruing at a rate of 5 5/8% per annum and payable semi-annually in cash in arrears on January

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15 and July 15 of each year, commencing July 15, 2014. The January 2022 Notes are guaranteed on a senior unsecured basis by Laredo Midstream and certain of the Company's future restricted subsidiaries.

The January 2022 Notes were issued pursuant to the Indenture in a transaction exempt from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act"). The January 2022 Notes were offered and sold only to qualified institutional buyers pursuant to Rule 144A under the Securities Act and to persons outside the United States pursuant to Regulation S under the Securities Act. The Company received net proceeds of \$442.2 million from the offering, after deducting the initial purchasers' discount and the estimated outstanding offering expenses. The Company used the net proceeds of the offering for general working capital purposes.

The Company may redeem, at its option, all or part of the January 2022 Notes at any time on and after January 15, 2017, at the applicable redemption price plus accrued and unpaid interest to the date of redemption. In addition, the Company may redeem, at its option, all or part of the January 2022 Notes at any time prior to January 15, 2017 at a redemption price equal to 100% of the principal amount of the January 2022 Notes redeemed plus the applicable premium and accrued and unpaid interest and additional interest, if any, to the date of redemption. Further, before January 15, 2017, the Company may on one or more occasions redeem up to 35% of the aggregate principal amount of the January 2022 Notes in an amount not exceeding the net proceeds from one or more private or public equity offerings at a redemption price of 105.625% of the principal amount of the January 2022 Notes, plus accrued and unpaid interest to the date of redemption, if at least 65% of the aggregate principal amount of the January 2022 Notes remains outstanding immediately after such redemption and the redemption occurs within 180 days of the closing date of each such equity offering. If a change of control occurs prior to January 15, 2015, the Company may redeem all, but not less than all, of the January 2022 Notes at a redemption price equal to 110% of the principal amount of the January 2022 Notes plus any accrued and unpaid interest to the date of redemption.

In connection with the closing of the offering of the January 2022 Notes, the Company entered into a registration rights agreement with the several initial purchasers named in the registration rights agreement, pursuant to which the Company filed a registration statement with the Securities and Exchange Commission ("SEC") that became effective with respect to an offer to exchange the January 2022 Notes for substantially identical notes (other than with respect to restrictions on transfer or any increase in annual interest rate) that are registered under the Securities Act. The offer to exchange the January 2022 Notes for substantially identical notes registered under the Securities Act was launched on April 22, 2014 with all notes exchanged on May 22, 2014.

3. May 2022 Notes

On April 27, 2012, the Company completed an offering of \$500.0 million in aggregate principal amount of 7 3/8% senior unsecured notes due 2022 (the "May 2022 Notes"). The May 2022 Notes will mature on May 1, 2022 and bear an interest rate of 7 3/8% per annum, payable semi-annually, in cash in arrears on May 1 and November 1 of each year, commencing November 1, 2012. The May 2022 Notes are fully and unconditionally guaranteed on a senior unsecured basis by Laredo Midstream and certain of the Company's future restricted subsidiaries.

4. 2019 Notes

On January 20, 2011, the Company completed an offering of \$350.0 million 9 1/2% senior unsecured notes due 2019 (the "January Notes") and on October 19, 2011, the Company completed an offering of an additional \$200.0 million 9 1/2% senior unsecured notes due 2019 (the "October Notes" and together with the January Notes, the "2019 Notes"). The 2019 Notes will mature on February 15, 2019 and bear an interest rate of 9 1/2% per annum, payable semi-annually, in cash in arrears on February 15 and August 15 of each year. The 2019 Notes are fully and unconditionally guaranteed on a senior unsecured basis by Laredo Midstream and certain of the Company's future restricted subsidiaries.

5. Senior Secured Credit Facility

As of September 30, 2014, the Fourth Amended and Restated Credit Agreement (as amended, the "Senior Secured Credit Facility"), which matures on November 4, 2018, had a borrowing base of \$1.0 billion and an aggregate elected commitment of \$825.0 million with \$75.0 million outstanding and was subject to an interest rate of 1.69%. It contains both financial and non-financial covenants, all of which the Company was in compliance with as of September 30,

2014. Laredo is required to pay an annual commitment fee on the unused portion of the financial institutions' commitment of 0.375% to 0.5%, based on the ratio of outstanding revolving credit to the total commitment under the Senior Secured Credit Facility. Additionally, the Senior Secured Credit Facility provides for the issuance of letters of credit, limited to the lesser of total capacity or \$20.0 million.

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Subsequent to September 30, 2014, the Company made additional borrowings on the Senior Secured Credit Facility and the borrowing base and the aggregate elected commitment amounts were increased. See Note O.1 for additional information.

6. Fair value of debt

The Company has not elected to account for its debt instruments at fair value. The following table presents the carrying amount and fair values of the Company's debt instruments for the periods presented:

(in thousands)	September 30, 2014		December 31, 2013	
	Carrying value	Fair value	Carrying value	Fair value
2019 Notes ⁽¹⁾	\$551,358	\$585,750	\$551,538	\$615,313
January 2022 Notes	450,000	444,150	—	—
May 2022 Notes	500,000	526,245	500,000	549,375
Senior Secured Credit Facility	75,000	75,046	—	—
Total value of debt	\$1,576,358	\$1,631,191	\$1,051,538	\$1,164,688

(1) The carrying value of the 2019 Notes includes the October Notes unamortized bond premium of \$1.4 million and \$1.5 million as of September 30, 2014 and December 31, 2013, respectively.

The fair values of the debt outstanding on the 2019 Notes, the January 2022 Notes and the May 2022 Notes were determined using the September 30, 2014 and December 31, 2013 quoted market price (Level 1) for each respective instrument. The fair value of the outstanding debt on the Senior Secured Credit Facility as of September 30, 2014 was estimated utilizing pricing models for similar instruments (Level 2). See Note H for information about fair value hierarchy levels.

E—Employee compensation

The Company has a Long-Term Incentive Plan (the "LTIP"), which provides for the granting of incentive awards in the form of restricted stock awards, restricted stock options awards, performance share awards, performance unit awards and other awards. The LTIP provides for the issuance of 10.0 million shares.

The Company recognizes the fair value of stock-based compensation granted to employees and directors over the requisite service period as a charge against earnings, net of amounts capitalized. The Company's stock-based compensation awards are accounted for as equity instruments. Stock-based compensation is included in "General and administrative" in the unaudited consolidated statements of operations. On January 1, 2014, the Company began capitalizing a portion of stock-based compensation for employees who are directly involved in the acquisition, exploration and development of oil and natural gas properties into the full-cost pool. Capitalized stock-based compensation is included as an addition to "Oil and natural gas properties" in the unaudited consolidated balance sheets.

1. Restricted stock awards

All restricted stock awards are treated as issued and outstanding in the accompanying unaudited consolidated financial statements. Per the award agreement terms, if an employee terminates employment prior to the restriction lapse date, the awarded shares are forfeited and canceled and are no longer considered issued and outstanding. If the employee's termination of employment is by reason of death or disability, all of the holder's restricted stock will automatically vest. Restricted stock awards granted to officers and employees vest in a variety of vesting schedules including (i) 20% at the grant date and then 20% annually thereafter, (ii) 33%, 33% and 34% per year beginning on the first anniversary date of the grant, (iii) 50% in year two and 50% in year three, (iv) fully on the first anniversary date of the grant and (v) fully on the third anniversary date of the grant. Restricted stock awards granted to non-employee directors vest fully on the first anniversary date of the grant.

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The following table reflects the outstanding restricted stock awards for the nine months ended September 30, 2014:

(in thousands, except for weighted-average grant date fair values)	Restricted stock awards	Weighted-average grant date fair value (per award)
Outstanding at December 31, 2013	1,799	\$19.17
Granted	1,209	\$25.81
Forfeited	(105)	) \$22.54
Vested ⁽¹⁾	(635)	) \$18.90
Outstanding at September 30, 2014	2,268	\$22.65

The vesting of certain restricted stock awards could result in federal and state income tax expense or benefit related (1) to the difference between the market price of the common stock at the date of vesting and the date of grant. See Note F for additional discussion regarding the tax impact of vested restricted stock awards.

The Company utilizes the closing stock price on the date of grant to determine the fair value of service vesting restricted stock awards. As of September 30, 2014, unrecognized stock-based compensation related to the restricted stock awards was \$33.8 million. Such cost is expected to be recognized over a weighted-average period of 1.7 years.

2. Restricted stock option awards

Restricted stock option awards granted under the LTIP vest and are exercisable in four equal installments on each of the four anniversaries of the date of the grant. The following table reflects the stock option award activity for the nine months ended September 30, 2014:

(in thousands, except for weighted-average exercise price and contractual term)	Restricted stock option awards	Weighted-average exercise price (per option)	Weighted-average remaining contractual term (years)
Outstanding at December 31, 2013	1,229	\$19.32	8.82
Granted	336	\$25.60	9.41
Exercised ⁽¹⁾	(95)	) \$19.93	7.98
Expired or canceled	—	\$—	—
Forfeited	(47)	) \$19.70	—
Outstanding at September 30, 2014	1,423	\$20.75	8.40
Vested and exercisable at end of period ⁽²⁾	352	\$20.38	7.91
Vested, exercisable, and expected to vest at end of period ⁽³⁾	1,390	\$20.75	8.40

The exercise of stock option awards could result in federal and state income tax expense or benefit related to the difference between the fair value of the stock option award at the date of grant and the intrinsic value of the stock option award when exercised. See Note F for additional discussion regarding the tax impact of exercised stock option awards.

(2) The aggregate intrinsic value of vested and exercisable options at September 30, 2014 was \$1.0 million.

(3) The aggregate intrinsic value of vested, exercisable and expected to vest options at September 30, 2014 was \$3.9 million.

The Company utilizes the Black-Scholes option pricing model to determine the fair values of restricted stock option awards and is recognizing the associated expense on a straight-line basis over the four-year requisite service period of the awards. Determining the fair value of equity-based awards requires judgment, including estimating the expected term that stock option awards will be outstanding prior to exercise and the associated volatility. As of September 30, 2014, unrecognized stock-based compensation related to the restricted option awards was \$9.4 million. Such cost is expected to be recognized over a weighted-average period of 2.56 years.

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The assumptions used to estimate the fair value of restricted stock options granted on February 27, 2014 are as follows:

Risk-free interest rate ⁽¹⁾	1.88	%
Expected option life ⁽²⁾	6.25 years	
Expected volatility ⁽³⁾	53.21	%
Fair value per stock option	\$13.41	

(1) U.S. Treasury yields as of the grant date were utilized for the risk-free interest rate assumption, matching the treasury yield terms to the expected life of the option.

(2) As the Company had limited exercise history at the time of valuation relating to terminations and modifications, expected option life assumptions were developed using the simplified method in accordance with GAAP.

(3) The Company utilized a peer historical look-back, which was weighted with the Company's own volatility, in order to develop the expected volatility.

In accordance with the LTIP and stock option agreement, the options granted will become exercisable in accordance with the following schedule based upon the number of full years of the optionee's continuous employment or service with the Company, following the date of grant:

Full years of continuous employment	Incremental percentage of option exercisable	Cumulative percentage of option exercisable	
Less than one	—	% —	%
One	25	% 25	%
Two	25	% 50	%
Three	25	% 75	%
Four	25	% 100	%

No shares of common stock may be purchased unless the optionee has remained in continuous employment with the Company for one year from the grant date. Unless terminated sooner, the option will expire if and to the extent it is not exercised within 10 years from the grant date. The unvested portion of a stock option award shall expire upon termination of employment, and the vested portion of a stock option award shall remain exercisable for (i) one year following termination of employment by reason of the holder's death or disability, but not later than the expiration of the option period, or (ii) 90 days following termination of employment for any reason other than the holder's death or disability, and other than the holder's termination of employment for cause. Both the unvested and the vested but unexercised portion of a stock option award shall expire upon the termination of the option holder's employment or service by the Company for cause.

3. Performance share awards

The Company performance share awards granted to management on February 27, 2014 ("Performance Share Awards") are subject to a combination of market and service vesting criteria. A Monte Carlo simulation prepared by an independent third party was utilized in order to determine the fair value of these awards at the date of grant. The Company has determined the Performance Share Awards are equity awards and is recognizing the associated expense on a straight-line basis over the three-year requisite service period of the awards. These awards will be settled in stock at the end of the requisite service period based on the achievement of certain performance criteria.

The Performance Share Awards have a performance period of January 1, 2014 to December 31, 2016 and any shares earned under such awards are expected to be issued in the first quarter of 2017 if the performance criteria is met. During the nine months ended September 30, 2014, 271,667 performance shares were awarded and all remain outstanding at September 30, 2014. As of September 30, 2014, unrecognized stock-based compensation related to the Performance Share Awards was \$6.0 million. Such cost is expected to be recognized over a weighted-average period of 2.41 years.

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The assumptions used to estimate the fair value of the Performance Share Awards are as follows:

Risk-free rate ⁽¹⁾	0.63	%
Dividend yield	—	%
Expected volatility ⁽²⁾	38.21	%
Laredo stock closing price as of February 27, 2014	\$25.60	
Fair value per performance share	\$28.56	

(1) The risk-free rate was derived using a zero-coupon yield derived from the Treasury Constant Maturities yield curve on the grant date.

(2) The Company utilized a peer historical look-back, weighted with the Company's own volatility, to develop the expected volatility.

4. Stock-based compensation award expense

The following has been recorded to stock-based compensation expense for the periods presented:

(in thousands)	Three months ended September		Nine months ended September	
	2014	2013	2014	2013
Restricted stock award compensation	\$5,880	\$4,707	\$16,122	\$11,105
Restricted stock option award compensation	931	1,169	2,736	2,451
Restricted performance share award compensation	631	—	1,476	—
Total stock-based compensation	7,442	5,876	20,334	13,556
Less amounts capitalized in oil and natural gas properties	(1,248	) —	(3,415) —
Net stock-based compensation expense	\$6,194	\$5,876	\$16,919	\$13,556

5. Performance unit awards

The performance unit awards issued to management on February 15, 2013 ("2013 Performance Unit Awards") and on February 3, 2012 ("2012 Performance Unit Awards") are subject to a combination of market and service vesting criteria. A Monte Carlo simulation prepared by an independent third party is utilized in order to determine the fair value of these awards at the date of grant and to re-measure the fair value at the end of each reporting period until settlement in accordance with GAAP. The volatility criteria utilized in the Monte Carlo simulation is based on the volatility of the Company's stock price and the stock price volatilities of a group of peer companies that have been determined to be most representative of the Company's expected volatility. These awards are accounted for as liability awards as they will be settled in cash at the end of the requisite service period based on the achievement of certain performance criteria. The liability and related compensation expense of these awards for each period is recognized by dividing the fair value of the total liability by the requisite service period and recording the pro rata share for the period for which service has already been provided. As there are inherent uncertainties related to these factors and the Company's judgment in applying them to the fair value determinations, there is risk that the recorded performance unit compensation may not accurately reflect the amount ultimately earned by the members of management.

The 44,481 outstanding 2013 Performance Unit Awards have a performance period of January 1, 2013 to December 31, 2015 and are expected to be paid in the first quarter of 2016 if the performance criteria are met. The 27,381 outstanding 2012 Performance Unit Awards have a performance period of January 1, 2012 to December 31, 2014 and are expected to be paid in the first quarter of 2015 if the performance criteria are met.

Compensation expense for the 2012 Performance Unit Awards and the 2013 Performance Unit Awards is recognized in "General and administrative" in the Company's unaudited consolidated statements of operations, and the corresponding liabilities are included in "Other current liabilities" and "Other noncurrent liabilities" in the unaudited consolidated balance sheets. Due to the quarterly re-measurement of the fair value of these awards as of September 30, 2014, compensation expense for the three months ended September 30, 2014 was a reversal of \$0.4 million.

Compensation expense related to these awards amounted to \$2.8 million in the three months ended September 30,

2013, and \$0.8 million and \$5.0 million in the nine months ended September 30, 2014 and 2013, respectively.

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F—Income taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating losses and tax credit carry-forwards. Under this method, deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income (loss) in the period that includes the enactment date. A valuation allowance is established to reduce deferred tax assets if it is determined it is more likely than not that the related tax benefit will not be realized. On a quarterly basis, management evaluates the need for and adequacy of valuation allowances based on the expected realizability of the deferred tax assets and adjusts the amount of such allowances, if necessary.

The Company evaluates uncertain tax positions for recognition and measurement in the consolidated financial statements. To recognize a tax position, the Company determines whether it is more likely than not that the tax position will be sustained upon examination, including resolution of any related appeals or litigation, based on the technical merits of the position. A tax position that meets the more-likely-than-not threshold is measured to determine the amount of benefit to be recognized in the consolidated financial statements. The amount of tax benefit recognized with respect to any tax position is measured as the largest amount of benefit that is greater than 50% likely of being realized upon settlement. The Company has no unrecognized tax benefits related to uncertain tax positions in the consolidated financial statements at September 30, 2014 or December 31, 2013.

The Company is subject to corporate income taxes and the Texas franchise tax. Income tax expense attributable to income from continuing operations for the periods presented consisted of the following:

(in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Current taxes	\$—	\$—	\$—	\$—
Deferred taxes	(45,778)	(10,048)	(35,511)	(31,205)
Income tax expense	\$(45,778)	\$(10,048)	\$(35,511)	\$(31,205)

The following presents the comprehensive provision for income taxes for the periods presented:

(in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Comprehensive provision for income taxes allocable to:				
Continuing operations	\$(45,778)	\$(10,048)	\$(35,511)	\$(31,205)
Discontinued operations	—	(321)	—	(765)
Comprehensive provision for income taxes	\$(45,778)	\$(10,369)	\$(35,511)	\$(31,970)

Income tax expense attributable to income from continuing operations before income taxes differed from amounts computed by applying the applicable federal income tax rate of 35% for the three and nine months ended September 30, 2014 and 34% for the three and nine months ended September 30, 2013 to pre-tax earnings as a result of the following:

(in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Income tax expense computed by applying the statutory rate	\$(45,215)	\$(7,434)	\$(34,932)	\$(27,014)
State income tax, net of federal tax benefit and increase in valuation allowance	247	(2,651)	1,881	(3,223)
Non-deductible stock-based compensation	(152)	(156)	(391)	(495)

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Stock-based compensation tax deficiency	(4)	(72)	(160)	(483)
Change in deferred tax valuation allowance	(22)	(20)	(1,134)	(49)
Other items	(632	)	285	)	(775	)	59)
Income tax expense	\$(45,778	)	\$(10,048	)	\$(35,511	)	\$(31,205)

The effective tax rate on income from continuing operations before income taxes was 35% and 46% for the three months ended September 30, 2014 and 2013, respectively, and 36% and 39% for the nine months ended September 30, 2014 and 2013, respectively. The Company's effective tax rate is affected by recurring permanent differences and by discrete items that may occur in any given year, but are not consistent from year to year.

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The impact of significant discrete items is separately recognized in the quarter in which they occur. The vesting of certain restricted stock awards could result in federal and state income tax expense or benefits related to the difference between the market price of the common stock at the date of vesting and the date of grant. The exercise of stock option awards could result in federal and state income tax expense or benefits related to the difference between the fair value of the stock option at the date of grant and the intrinsic value of the stock option when exercised. The tax impact resulting from vestings of restricted stock awards and exercise of option awards are discrete items. During the three and nine months ended September 30, 2014 and 2013, certain shares related to restricted stock awards vested at times when the Company's stock price was lower than the fair value of those shares at the time of grant. As a result, the income tax deduction related to such shares is less than the expense previously recognized for book purposes. During the three and nine months ended September 30, 2014, certain restricted stock options were exercised. The income tax deduction related to the intrinsic value of the options was less than the expense previously recognized for book purposes. In accordance with GAAP, such shortfalls reduce additional paid-in capital to the extent windfall tax benefits have been previously recognized. However, the Company has not previously recognized any windfall tax benefits. Therefore, such shortfalls are included in income tax expense attributable to continuing operations.

The following table presents the tax impact of these shortfalls for the periods presented:

(in thousands)	Three months ended		Nine months ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Vesting of restricted stock	\$4	\$2	\$5	\$427
Exercise of restricted stock options	1	72	158	72
Tax impact of shortfalls	\$5	\$74	\$163	\$499

The Company filed its 2013 federal and Oklahoma income tax returns during the three months ended September 30, 2014. As a result, the Company recognized an aggregate expense from tax return related items, which is a discrete item, of \$0.6 million for each of the three and nine month periods ending September 30, 2014, which is included in income tax expense attributable to continuing operations for these respective periods. The tax expense impact of the prior-year return to provision true-up was \$2.4 million for each of the three and nine month periods ended September 30, 2013.

Significant components of the Company's deferred tax liabilities for the periods presented are as follows:

(in thousands)	September 30,	December 31,
	2014	2013
Net operating loss carry-forward	\$337,933	\$284,890
Oil and natural gas properties and equipment	(396,802)	(278,735)
Derivatives	(4,054)	(30,859)
Stock-based compensation	9,624	6,578
Accrued bonus	3,133	3,740
Capitalized interest	2,705	2,099
Other	586	(240)
Gross deferred tax liability	(46,875)	(12,527)
Valuation allowance	(1,295)	(132)
Net deferred tax liability	\$(48,170)	\$(12,659)

Net deferred tax assets and liabilities were classified in the unaudited consolidated balance sheets as follows for the periods presented:

(in thousands)	September 30,	December 31,
	2014	2013
Deferred tax asset	\$1,255	\$3,634
Deferred tax liability	(49,425)	(16,293)
Net deferred tax liability	\$(48,170)	\$(12,659)

The Company had federal net operating loss carry-forwards totaling \$956.8 million and state of Oklahoma net operating loss carry-forwards totaling \$120.5 million as of September 30, 2014. These carry-forwards begin expiring in 2026. As of September 30, 2014, the Company believes the federal and the state of Oklahoma net operating loss carry-forwards are fully realizable. The Company considered all available evidence, both positive and negative in determining whether, based on the weight of that evidence, a valuation allowance was needed on either the federal or the Oklahoma net operating loss carry-forwards. Such consideration included estimated future projected earnings based on existing reserves and projected future cash

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flows from its oil and natural gas reserves (including the timing of those cash flows), the reversal of deferred tax liabilities recorded as of September 30, 2014, the Company's ability to capitalize intangible drilling costs, rather than expensing these costs in order to prevent an operating loss carry-forward from expiring unused, and future projections of Oklahoma sourced income.

The Company's federal and state operating loss carry-forwards include windfall tax deductions from vestings of certain restricted stock awards and stock option exercises that were not recorded in the Company's income tax provision. The amount of windfall tax benefit recognized in additional paid-in capital is limited to the amount of benefit realized currently in income taxes payable. As of September 30, 2014, the Company had suspended additional paid-in capital credits of \$4.5 million related to windfall tax deductions. Upon realization of the net operating loss carry-forwards from such windfall tax deductions, the Company would record a benefit of up to \$4.5 million in additional paid-in capital.

The Company maintains a valuation allowance to reduce certain deferred tax assets to amounts that are more likely than not to be realized. As of September 30, 2014, a full valuation allowance of \$1.3 million was recorded against the deferred tax asset related to the Company's charitable contribution carry-forward of \$3.6 million.

The Company's income tax returns for the years 2011 through 2013 remain open and subject to examination by federal tax authorities and/or the tax authorities in Oklahoma, Texas and Louisiana which are the jurisdictions where the Company has or had operations. Additionally, the statute of limitations for examination of federal net operating loss carry-forwards typically does not begin to run until the year the attribute is utilized in a tax return. The Company's 2011 federal income tax return is currently under examination.

G—Derivatives

1. Commodity derivatives

The Company engages in derivative transactions such as collars, swaps, puts and basis swaps to hedge price risks due to unfavorable changes in oil and natural gas prices related to its oil and natural gas production. As of September 30, 2014, the Company had 53 open derivative contracts with financial institutions which extend from October 2014 to December 2017. None of these contracts were designated as hedges for accounting purposes. The contracts are recorded at fair value on the balance sheet and gains and losses are recognized in current period earnings. Gains and losses on derivatives are reported on the unaudited consolidated statements of operations in the respective "Gain (loss) on derivatives" amounts.

Each collar transaction has an established price floor and ceiling. When the settlement price is below the price floor established by these collars, the Company receives an amount from its counterparty equal to the difference between the settlement price and the price floor multiplied by the hedged contract volume. When the settlement price is above the price ceiling established by these collars, the Company pays its counterparty an amount equal to the difference between the settlement price and the price ceiling multiplied by the hedged contract volume.

Each swap transaction has an established fixed price. When the settlement price is below the fixed price, the counterparty pays the Company an amount equal to the difference between the settlement price and the fixed price multiplied by the hedged contract volume. When the settlement price is above the fixed price, the Company pays its counterparty an amount equal to the difference between the settlement price and the fixed price multiplied by the hedged contract volume.

Each put transaction has an established floor price. The Company pays its counterparty a premium in order to enter into the put transaction. When the settlement price is below the floor price, the counterparty pays the Company an amount equal to the difference between the settlement price and the fixed price multiplied by the hedged contract volume. When the settlement price is above the floor price, the put option expires.

The oil basis swap transaction has an established fixed basis differential. The Company's oil basis swap differential is between the West Texas Intermediate Argus Midland ("Argus Midland") index crude oil price and the West Texas

Intermediate Argus Cushing ("Argus Cushing") index crude oil price. When the Argus Cushing price less the fixed basis differential is greater than the actual Argus Midland price, the difference multiplied by the hedged contract volume is paid to the Company by the counterparty. When the Argus Cushing price less the fixed basis differential is less than the actual Argus Midland price, the difference multiplied by the hedged contract volume is paid by the Company to the counterparty.

During the first quarter of 2014, the Company unwound a physical commodity contract and the associated oil basis swap financial derivative contract which hedged the differential between the Light Louisiana Sweet Argus and the Brent International Petroleum Exchange index oil prices. Prior to its unwind, the physical commodity contract qualified to be scoped

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out of mark-to-market accounting in accordance with the normal purchase and normal sale scope exemption. Once modified to settle financially in the unwind agreement, the contract ceased to qualify for the normal purchase and normal sale scope exemption, therefore requiring it to be marked-to-market. The Company received net proceeds of \$76.7 million from the early termination of these contracts. The Company agreed to settle the contracts early due to the counterparty's decision to exit the physical commodity trading business.

During the nine months ended September 30, 2014, the Company entered into additional commodity contracts to hedge a portion of its estimated future production. The following table summarizes information about these additional commodity derivative contracts:

	Aggregate volumes	Swap price	Floor price	Ceiling price	Contract period	
Oil (volumes in Bbl):						
Swap	288,000	\$103.56	\$—	\$—	July 2014	- December 2014
Swap	672,000	\$96.56	\$—	\$—	January 2015	- December 2015
Price collars	696,000	\$—	\$80.00	\$100.20	January 2016	- December 2016
Swap	640,500	\$84.85	\$—	\$—	January 2016	- December 2016
Swap	933,300	\$84.80	\$—	\$—	January 2016	- December 2016
Price collars	2,263,000	\$—	\$80.00	\$100.00	January 2017	- December 2017
Natural gas (volumes in MMBtu):						
Swaps	5,508,000	\$4.32	\$—	\$—	March 2014	- December 2014
Price collar	3,797,500	\$—	\$4.00	\$5.50	May 2014	- December 2014
Price collar	20,440,000	\$—	\$3.00	\$5.95	January 2015	- December 2015
Price collar	18,666,000	\$—	\$3.00	\$5.60	January 2016	- December 2016

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The following table summarizes open positions as of September 30, 2014, and represents, as of such date, derivatives in place through December 2017 on annual production volumes:

	Remaining Year 2014	Year 2015	Year 2016	Year 2017
Oil positions: ⁽¹⁾				
Puts:				
Hedged volume (Bbl)	135,000	456,000	—	—
Weighted-average price (\$/Bbl)	\$75.00	\$75.00	\$—	\$—
Swaps:				
Hedged volume (Bbl)	685,999	672,000	1,573,800	—
Weighted-average price (\$/Bbl)	\$96.35	\$96.56	\$84.82	\$—
Collars:				
Hedged volume (Bbl)	736,500	6,557,020	2,556,000	2,263,000
Weighted-average floor price (\$/Bbl)	\$86.42	\$79.81	\$80.00	\$80.00
Weighted-average ceiling price (\$/Bbl)	\$104.89	\$95.40	\$93.77	\$100.00
Basis swap: ⁽²⁾				
Hedged volume (Bbl)	552,000	—	—	—
Weighted-average price (\$/Bbl)	\$(1.00)	\$—	\$—	\$—
Natural gas positions: ⁽³⁾				
Swaps:				
Hedged volume (MMBtu)	1,656,000	—	—	—
Weighted-average price (\$/MMBtu)	\$4.32	\$—	\$—	\$—
Collars:				
Hedged volume (MMBtu)	3,826,000	28,600,000	18,666,000	—
Weighted-average floor price (\$/MMBtu)	\$3.37	\$3.00	\$3.00	\$—
Weighted-average ceiling price (\$/MMBtu)	\$5.50	\$5.96	\$5.60	\$—

Oil derivatives are settled based on the average of the daily settlement prices for the First Nearby Month of the (1) West Texas Intermediate NYMEX Light Sweet Crude Oil Futures Contract for each NYMEX Trading Day during each month.

(2) The associated oil basis swap is settled on the differential between the Argus Midland and the Argus Cushing index oil prices.

(3) Natural gas derivatives are settled based on the Inside FERC index price for West Texas Waha for the calculation period.

The following represents cash settlements received (paid) for matured derivatives for the periods presented:

(in thousands)	Three months ended		Nine months ended	
	September 30, 2014	2013	September 30, 2014	2013
Commodity derivatives received (paid)	\$4,531	\$(3,975)	\$(1,320)	\$888
Interest rate derivatives paid	—	(94)	—	(300)
Cash settlements received (paid) for matured derivatives, net	\$4,531	\$(4,069)	\$(1,320)	\$588

2. Interest rate derivatives

The Company is exposed to market risk for changes in interest rates related to any drawn amount on its Senior Secured Credit Facility. In prior periods, interest rate derivative agreements were used to manage a portion of the

exposure related to changing interest rates by converting floating-rate debt to fixed-rate debt. If the London Interbank Offered Rate ("LIBOR") was lower than the fixed rate in the contract, the Company was required to pay the counterparties the difference, and conversely, the counterparties were required to pay the Company if LIBOR was higher than the fixed rate in the contract. The Company did not designate the interest rate derivatives as cash flow hedges; therefore, the changes in fair value of these instruments were recorded in current earnings. The Company had one interest rate swap and one interest rate cap outstanding for a notional

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amount of \$100.0 million with fixed pay rates of 1.11% and 3.00%, respectively, until their expiration in September 2013. No interest rate derivatives were in place during the period ended September 30, 2014.

3. Balance sheet presentation

The Company's oil and natural gas commodity derivatives are presented on a net basis in "Derivatives" on the unaudited consolidated balance sheets.

The following summarizes the fair value of derivatives outstanding on a gross basis as of September 30, 2014 and December 31, 2013, respectively:

(in thousands)	September 30, 2014	December 31, 2013
Assets:		
Commodity derivatives:		
Oil derivatives	\$25,988	\$140,496
Natural gas derivatives	1,930	657
Total assets	\$27,918	\$141,153
Liabilities:		
Commodity derivatives:		
Oil derivatives ⁽¹⁾	\$16,081	\$56,818
Natural gas derivatives ⁽²⁾	1,139	2,278
Total liabilities	\$17,220	\$59,096
Net derivative position	\$10,698	\$82,057

(1) The oil derivatives fair value includes a deferred premium liability of \$10.1 million and \$11.1 million as of September 30, 2014 and December 31, 2013, respectively.

(2) The natural gas derivatives fair value includes a deferred premium liability of \$1.0 million and \$1.6 million as of September 30, 2014 and December 31, 2013, respectively.

By using derivatives to hedge exposures to changes in commodity prices and interest rates, the Company exposes itself to credit risk and market risk. Market risk is the exposure to changes in the market price of oil and natural gas, which are subject to fluctuations from a variety of factors, including changes in supply and demand. Credit risk is the failure of the counterparty to perform under the terms of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes the Company, thereby creating credit risk. The Company's counterparties are or originally were participants in the Senior Secured Credit Facility which is secured by the Company's oil and natural gas reserves; therefore, the Company is not required to post any collateral. The Company does not require collateral from its counterparties. The Company minimizes the credit risk in derivatives by: (i) limiting its exposure to any single counterparty, (ii) entering into derivatives only with counterparties that are also lenders in the Senior Secured Credit Facility and meet the Company's minimum credit quality standard, or have a guarantee from an affiliate that meets the Company's minimum credit quality standard, and (iii) monitoring the creditworthiness of the Company's counterparties on an ongoing basis. In accordance with the Company's standard practice, its commodity and interest rate derivatives are subject to counterparty netting under agreements governing such derivatives and, therefore, the risk of such loss is somewhat mitigated as of September 30, 2014.

H—Fair value measurements

The Company accounts for its oil and natural gas commodity derivatives and, in prior periods, its interest rate derivatives, at fair value. The fair value of derivatives is determined utilizing pricing models for similar instruments. The models use a variety of techniques to arrive at fair value, including quotes and pricing analysis. Inputs to the pricing models include publicly available prices and forward curves generated from a compilation of data gathered from third parties.

The Company has categorized its assets and liabilities measured at fair value, based on the priority of inputs to the valuation technique, into a three-level fair value hierarchy. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3).

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Assets and liabilities recorded at fair value on the unaudited consolidated balance sheets are categorized based on inputs to the valuation techniques as follows:

Level 1— Assets and liabilities recorded at fair value for which values are based on unadjusted quoted prices for identical assets or liabilities in an active market that management has the ability to access. Active markets are considered to be those in which transactions for the assets or liabilities occur in sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2— Assets and liabilities recorded at fair value for which values are based on quoted prices in markets that are not active or model inputs that are observable either directly or indirectly for substantially the full term of the assets or liabilities. Substantially all of these inputs are observable in the marketplace throughout the full term of the price risk management instrument and can be derived from observable data or supported by observable levels at which transactions are executed in the marketplace.

Level 3— Assets and liabilities recorded at fair value for which values are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. Unobservable inputs are not corroborated by market data. These inputs reflect management’s own assumptions about the assumptions a market participant would use in pricing the asset or liability.

When the inputs used to measure fair value fall within different levels of the hierarchy in a liquid environment, the level within which the fair value measurement is categorized is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company conducts a review of fair value hierarchy classifications on an annual basis. Changes in the observability of valuation inputs may result in a reclassification for certain financial assets or liabilities. Transfers between fair value hierarchy levels are recognized and reported in the period in which the transfer occurred. No transfers between fair value hierarchy levels occurred during the nine months ended September 30, 2014 or 2013.

1. Fair value measurement on a recurring basis

The following presents the Company’s fair value hierarchy for assets and liabilities measured at fair value on a recurring basis for the periods presented:

(in thousands)	Level 1	Level 2	Level 3	Total fair value
As of September 30, 2014:				