

Storm Cat Energy CORP
Form 10-Q
August 11, 2008
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

- x** **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

- o** **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: 001-32628

STORM CAT ENERGY CORPORATION

(Exact name of registrant as specified in its charter)

British Columbia
(State or other jurisdiction
of incorporation or organization)

06-1762942
(I.R.S. Employer
Identification No.)

1125 17th Street, Suite 2310
Denver, Colorado
(Address of principal executive offices)

80202
(Zip Code)

(registrant's telephone number, including area code): **(303) 991-5070**

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, or an accelerated filer, or 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
(Do not check if smaller reporting company) 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

As of August 8, 2008, there were 81,278,549 common shares outstanding.

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(stated in thousands of U.S. dollars, except share amounts)

	June 30, 2008 (Unaudited)	December 31, 2007 (Audited)
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 2,068	\$ 1,133
Accounts receivable:		
Joint interest billing	3,053	1,701
Revenue receivable	3,792	2,444
Fair value of derivative instruments		1,760
Prepaid costs and other current assets	2,224	2,941
Total current assets	11,137	9,979
PROPERTY AND EQUIPMENT (full cost method), at cost:		
Oil and gas properties:		
Unproved properties	57,043	51,438
Proved properties	100,283	78,096
Less accumulated depreciation, depletion, and amortization	(17,038)	(12,228)
Oil and gas properties, net	140,288	117,306
Other property	1,149	1,180
Less accumulated depreciation	(926)	(778)
Total other property, net	223	402
Total property and equipment, net	140,511	117,708
OTHER NON-CURRENT ASSETS:		
Restricted cash	168	685
Debt issuance costs, net of accumulated amortization of \$2,686 and \$1,988, respectively	2,963	3,435
Accounts receivable long-term		759
Total other non-current assets	3,131	4,879
Total assets	\$ 154,779	\$ 132,566
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$ 10,588	\$ 5,825
Revenue payable	3,191	1,678
Accrued and other liabilities	8,090	4,131
Interest payable		12
Share-based payments liability	609	394
Fair value of derivative instruments	11,708	
Bank Debt	64,625	
Total current liabilities	98,811	12,040
NON-CURRENT LIABILITIES:		
Bank Debt		43,056
Ad valorem taxes payable	852	
Asset retirement obligation	1,844	1,713
Fair value of derivative instruments	2,839	183
Convertible notes payable	50,195	50,195
Total non-current liabilities	55,730	95,147
Total liabilities	154,541	107,187

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Commitments and Contingencies (Notes 2 and 11)

SHAREHOLDERS' EQUITY:

Common shares, without par value, unlimited authorized, issued and outstanding: 81,278,549 at June 30, 2008 and 81,087,320 at December 31, 2007	69,834	69,834
Additional paid-in capital	6,028	5,640
Accumulated other comprehensive income (loss)	(9,709)	7,483
Accumulated deficit	(65,915)	(57,578)
Total shareholders' equity	238	25,379
Total liabilities and shareholders' equity	\$ 154,779	\$ 132,566

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

Table of Contents**STORM CAT ENERGY CORPORATION****CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)****(stated in thousands of U.S. dollars, except share and per share amounts)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
NATURAL GAS REVENUE	\$ 6,550	\$ 3,668	\$ 12,567	\$ 7,580
OPERATING EXPENSES:				
Gathering and transportation	1,340	398	2,143	958
Lease operating expenses	2,407	1,256	4,810	2,159
General and administrative	1,819	3,491	3,536	6,152
Depreciation, depletion, amortization and accretion of asset retirement obligation	2,856	1,879	5,018	3,513
Total operating expenses	8,422	7,024	15,507	12,782
Operating loss	(1,872)	(3,356)	(2,940)	(5,202)
OTHER INCOME (EXPENSE):				
Interest expense	(2,462)	(1,519)	(4,731)	(2,148)
Interest and other miscellaneous income	52	101	32	133
Amortization of deferred financing costs	(411)		(698)	
Total other income (expense)	(2,821)	(1,418)	(5,397)	(2,015)
Loss before taxes	(4,693)	(4,774)	(8,337)	(7,217)
Recovery of future income tax asset from flow-through shares		182		1,278
NET LOSS	\$ (4,693)	\$ (4,592)	\$ (8,337)	\$ (5,939)
Basic and diluted loss per share	\$ (0.06)	\$ (0.06)	\$ (0.10)	\$ (0.07)
Weighted average number of shares outstanding	81,214,884	81,045,122	81,151,150	80,816,505

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

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STORM CAT ENERGY CORPORATION
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE LOSS
FOR THE SIX MONTHS ENDED JUNE 30, 2008

(Unaudited)

(stated in thousands of U.S. dollars, except share amounts)

	Common Stock Shares	Amount	Additional Paid-in Capital	Other Comprehensive Income (Loss)	Accumulated Deficit	Total Shareholders Equity
BALANCE AT DECEMBER 31, 2007	81,087,320	\$ 69,834	\$ 5,640	\$ 7,483	\$ (57,578)	\$ 25,379
Restricted Share Units vested	191,229					
Share-based payments			388			388
Net loss					(8,337)	(8,337)
Net change in foreign currency translation and fair value of derivative instruments				(17,192)		(17,192)
Other comprehensive loss (Note 10)						(25,529)
BALANCE AT JUNE 30, 2008	81,278,549	\$ 69,834	\$ 6,028	\$ (9,709)	\$ (65,915)	\$ 238

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

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STORM CAT ENERGY CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(stated in thousands of U.S. dollars)

	Six Months Ended June 30,	
	2008	2007
Cash flows from operating activities:		
Net loss	\$ (8,337)	\$ (5,939)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Recovery of future income tax asset from flow-through shares		(1,252)
Share-based payments	625	1,161
Depreciation, depletion, amortization and accretion of asset retirement obligation	5,018	3,521
Amortization of debt issuance costs	698	
Changes in operating assets and liabilities:		
Accounts receivable	(2,694)	(761)
Other current assets	700	381
Accounts payable	257	(2,674)
Accrued interest and other current liabilities	5,103	(1,461)
Net cash provided by (used in) operating activities	1,370	(7,024)
Cash flows from investing activities:		
Restricted cash	1,264	(8)
Capital expenditures - oil and gas properties	(22,801)	(32,386)
Capital expenditures - other assets	21	(23)
Net cash used in investing activities	(21,516)	(32,417)
Cash flows from financing activities:		
Issuance of common stock		914
Debt issuance costs		(3,556)
Proceeds from (repayment of) bank debt	21,569	(13,278)
Proceeds from convertible notes payable		50,194
Net cash provided by financing activities	21,569	34,274
Effect of exchange rate changes on cash	(488)	883
Net decrease in cash and cash equivalents	935	(4,284)
Cash and cash equivalents at beginning of period	1,133	5,299
Cash and cash equivalents at end of period	\$ 2,068	\$ 1,015
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 5,224	\$ 2,449
Supplemental disclosure of non-cash investing and financing activities:		
Capital accruals and asset additions	\$ 13,566	\$ 6,700
Increase in asset retirement obligation	\$ 89	\$ (284)
Change in fair value derivatives	\$ (16,123)	\$ (1,360)

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

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STORM CAT ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Storm Cat Energy Corporation, together with its consolidated subsidiaries (Storm Cat or the Company), is an independent oil and gas company focused primarily on the pursuit, exploration and development of large unconventional gas reserves from fractured shales, coal beds and tight sand formations and, secondarily, from conventional formations. We have producing properties in Wyoming's Powder River Basin (PRB) and in Arkansas' Arkoma Basin (Fayetteville Shale). Our primary exploration and development acreage is located in the United States and Canada. Unless the context otherwise requires, the terms Storm Cat, we , us, our and the Company , when used herein refer to Storm Cat Energy Corporation, together with its operating subsidiaries. When the context requires, we refer to these entities separately.

NOTE 1. BASIS OF PRESENTATION

The accompanying Consolidated Financial Statements of Storm Cat, with the exception of the Consolidated Balance Sheet at December 31, 2007, have not been audited by independent public accountants and have been prepared in accordance with generally accepted accounting principals (GAAP) in the U.S. In the opinion of management, the accompanying financial statements reflect all adjustments necessary to present fairly our financial position at June 30, 2008, our loss for the three and six months ended June 30, 2008 and 2007 and cash flows for the six months ended June 30, 2008 and 2007. All such adjustments are of a normal recurring nature. In preparing the accompanying financial statements, management has made certain estimates and assumptions that affect reported amounts in the financial statements and disclosures of contingencies. Actual results may differ from those estimates. Certain amounts presented in prior period financial statements have been reclassified for consistency with current period presentation. The results for interim periods are not necessarily indicative of annual results.

Certain disclosures have been condensed or omitted from these financial statements. Accordingly, they should be read along with the Consolidated Financial Statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2007.

NOTE 2. LIQUIDITY

At June 30, 2008, the Company was not in compliance with certain of the financial and minimum average daily production covenants set forth in the Amended Credit Agreement (as defined in Note 6 below). It is likely that we will not be in compliance with the covenants for the next twelve months. Accordingly, the \$64.6 million outstanding under the Credit Facility (as defined in Note 6 below) at June 30, 2008 has been classified as a current liability in the accompanying Consolidated Balance Sheet.

The Company has a working capital deficit of \$87.7 million at June 30, 2008. This compares to a deficit in working capital of \$2.0 million at December 31, 2007 and \$12.7 million at March 31, 2008. Reclassification of \$64.6 million outstanding under our Credit Facility to current liabilities is the primary reason for the large increase in our working capital deficit.

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The Company is considering various alternatives to remedy the noncompliance with the covenants set forth in the Amended Credit Agreement, the working capital deficit, and to provide funding for operations and future capital spending, including the possible sale of assets, amendment of the Amended Credit Agreement, or raising additional equity capital.

NOTE 3. SIGNIFICANT ACCOUNTING POLICIES

Please see our Annual Report on Form 10-K for the year ended December 31, 2007 for a comprehensive listing of our accounting policies.

Foreign Currency

We are exposed to fluctuations in foreign currencies, primarily through our operations in Canada. We monitor this exposure but have not entered into any hedging arrangements to protect from currency fluctuations. As of June 30, 2008, \$2.07 million U.S. dollar equivalent, or 100% of our cash, was held in U.S. dollars.

For the six months ended June 30, 2008, balances in the Consolidated Statements of Operations were converted from Canadian to U.S. dollars at a weighted average exchange rate of \$0.9932 CDN to \$1.00 U.S., and Consolidated Balance Sheet balances were converted at a rate of \$0.9900 CDN to \$1.00 U.S. based on the exchange rate on June 30, 2008.

For the six months ended June 30, 2007, balances in the Consolidated Statements of Operations were converted from Canadian to U.S. dollars at a weighted average exchange rate of \$0.8819 CDN to \$1.00 U.S.

Fair Value Measurements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157 *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. On February 12, 2008, the FASB issued Staff Position No. FAS 157-2 (FSP 157-2) which proposed a one year deferral for the implementation of SFAS 157 for non-financial assets and liabilities that are recognized or disclosed at fair value on a nonrecurring basis (less frequent than annually).

On January 1, 2008 we elected to implement SFAS 157 with the one-year deferral. Given the nature of our current financial instruments, the adoption of SFAS 157 did not have a material impact on our financial position, results of operations or cash flows.

The estimated fair values of derivatives included in the Consolidated Balance Sheets as of June 30, 2008 and December 31, 2007 are summarized below. The increase in the net derivative liability from December 31, 2007 to June 30, 2008 is primarily attributable to the effect of higher natural gas prices.

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Assets and liabilities recorded at fair value in the Consolidated Balance Sheets are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Hierarchical levels defined by SFAS 157 and directly related to the amount of subjectivity associated with the inputs to fair valuation of these assets and liabilities are as follows:

Level I Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities at the measurement date.

Level II Inputs (other than quoted prices included in Level I) are either directly or indirectly observable for the asset or liability through correlation with market data at the measurement date and for the duration of the instrument's anticipated life.

Level III Inputs reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model.

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In Thousands	Fair Value Measurements	
	June 30, 2008 Significant Other Observable Inputs (Level II)	December 31, 2007 Significant Other Observable Inputs (Level II)
Derivative assets:		
Fixed-price natural gas commodity swaps	\$	\$ 1,760
Derivative liabilities:		
Fixed-price natural gas commodity swaps	(14,547)	(183)
Net derivative asset (liability)	\$ (14,547)	\$ 1,577

NOTE 4. DERIVATIVE FINANCIAL INSTRUMENTS*Natural Gas Commodity Hedges*

Realized gains or losses from the settlement of natural gas derivative contracts are reported as natural gas revenues in the Consolidated Statements of Operations. Changes in the fair value of derivative instruments designated as cash flow hedges, to the extent they are effective in offsetting cash flows attributable to the hedged risk, are recorded in accumulated other comprehensive loss in the Consolidated Balance Sheets. Any change in fair value resulting from ineffectiveness is recognized currently in derivative loss in the Consolidated Statements of Operations.

As of June 30, 2008, all natural gas derivative instruments qualified as cash flow hedges for accounting purposes under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. We anticipate that all forecasted transactions will occur by the end of their originally specified periods. All contracts are entered into for other than trading purposes.

Our natural gas hedges are indexed to the first of the month CIG index. The CIG index is the same index that determines the actual natural gas revenue received by us for our PRB production. Therefore, the hedges are highly correlated to changes in cash flows from natural gas sales.

To mitigate a portion of the potential exposure to adverse market changes, we have entered into various derivative contracts. As of June 30, 2008, we had hedge contracts in place through December 2010 for a total of approximately 8,292,800 MMBtu of anticipated production from our PRB properties (see Item 3. *Quantitative and Qualitative Disclosures About Market Risk* for a detailed listing of our commodity swaps).

We recognized a \$17.7 million loss on the fair value of our derivative contracts in the first six months of 2008, and \$0.5 million gain for the same period in 2007. The table below summarizes derivative instrument gain (loss) activity:

Three Months Ended

Six Months Ended

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Derivative Instrument Gain (Loss) Activity In Thousands	2008	June 30, 2007	2008	June 30, 2007
Derivative contract settlements reflected in natural gas revenue	\$ (1,643)	\$ 1,395	\$ (1,527)	\$ 1,820
Derivative contracts reflected in other comprehensive loss	\$ (8,586)	\$ 231	\$ (16,123)	\$ (1,360)
Total derivative instrument gain (loss)	\$ (10,229)	\$ 1,626	\$ (17,650)	\$ 460

NOTE 5. OIL AND GAS PROPERTIES

Accounting for Oil and Gas Properties

We follow the full cost method of accounting for oil and gas operations whereby all costs of exploring for and developing oil and gas reserves are initially capitalized on a country-by-country (cost center) basis. Capitalized costs, less estimated salvage value, are depleted using the units-of-production method whereby historical costs and future development costs are amortized over the total estimated proved reserves. Costs of acquiring and evaluating unproved properties and major development projects are initially excluded from the depletion and depreciation calculation until it is determined whether or not proved reserves can be assigned to such properties. These costs are assessed periodically to ascertain whether impairment has occurred (i.e., impairment tests). Please refer

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to Regulation S-X Rule 4-10(c)(4) for full discussion regarding impairment tests. There were no impairment charges in either the first six months of 2008 or 2007.

In the first six months of 2008, we invested \$1.8 million in lease rentals, geophysical and geological activities and capitalized interest. During this period, we also invested \$25.8 million in various capital projects as follows:

- in the PRB, we invested a total of \$15.7 million for drilling, completion, compression, pipeline expenditures and acquisitions;
- in Fayetteville, we invested \$9.4 million in capital for drilling and completion; and
- in Elk Valley, Canada, we invested \$0.7 million.

Asset Retirement Obligation

The estimated fair value of the future costs associated with dismantlement, abandonment and restoration of natural gas properties is recorded when the assets are placed into service, generally through acquisition or completion of a well. The net estimated costs are discounted to present values using a risk-adjusted rate over the estimated economic life of the properties. Such costs are capitalized as part of the basis of the related asset and are depleted as part of the applicable full cost pool. The associated liability is recorded initially as a long-term liability. Subsequent adjustments to the initial asset and liability are recorded to reflect revisions to estimated future cash flow requirements. In addition, the liability is adjusted to reflect accretion expense as well as settlements during the period.

A reconciliation of the changes in the asset retirement obligation for the six months ended June 30, 2008 and 2007, respectively, is as follows:

In Thousands	Six Months Ended June 30,	
	2008	2007
Asset retirement obligation at January 1	\$ 1,713	\$ 1,871
Adjustment for revision of estimated life and interest rate in the Powder River Basin	(1)	(400)
Additional liabilities incurred	90	118
Accretion expense	51	98
Foreign currency translation	(9)	34
Asset retirement obligation at June 30	\$ 1,844	\$ 1,721

NOTE 6. BANK CREDIT FACILITY

On December 27, 2007, Storm Cat Energy (USA) Corporation (Storm Cat (USA)), a wholly owned subsidiary of Storm Cat, entered into that certain Credit Agreement, dated December 27, 2007, by and among Storm Cat (USA), Wells Fargo Foothill LLC (Wells Fargo), as Agent, and the additional lenders party thereto (the Credit Agreement), which provides for certain credit facilities (the Credit Facility). Additionally, Storm Cat agreed to guarantee the obligations of Storm Cat (USA) under the Credit Facility. On April 17, 2008, Storm Cat, Storm Cat

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(USA), and their subsidiaries entered into a First Amendment to Credit Agreement (the Amendment and the Credit Agreement as amended by the Amendment, the Amended Credit Agreement). The Credit Facility consists of a term loan facility and a revolving facility. The Amended Credit Agreement provides for a semi-annual evaluation of such amount, determined based on Storm Cat's oil and natural gas reserves.

As of June 30, 2008, the Credit Facility consists of a term loan facility in an aggregate principal amount of \$40.0 million and a revolving facility in an aggregate principal amount of \$25.0 million. Storm Cat's borrowing base under the Credit Facility was \$65.0 million as of June 30, 2008. As of June 30, 2008, we had a total of \$64.6 million outstanding pursuant to the Amended Credit Agreement, which consisted of \$40.0 million on the term loan facility and \$24.6 million on the revolving facility.

Storm Cat and the subsidiary guarantors have also executed and delivered certain other related agreements and documents pursuant to the Credit Facility, including a guaranty agreement, security and pledge agreement and mortgages. The obligations of Storm Cat, Storm Cat (USA), and their subsidiaries under the Credit Facility are secured by a first priority security interest in favor of Wells Fargo for the benefit of the lenders, in Storm Cat and its subsidiaries' material tangible and intangible assets, and proved reserves, among other things.

Each loan under the Credit Facility bears interest at a base rate or Eurodollar rate, as requested by Storm Cat, plus an applicable percentage based on Storm Cat's usage of the facility. The applicable margin above the base rate and the Eurodollar rate for the term loan is 6.75% and 8.00%, respectively. The applicable margin above the base rate and the Eurodollar rate for the revolving Credit Facility ranges from 0.75% to 1.25% and 2.00% and 2.50%, respectively, in each case depending on our usage under the borrowing base. Interest on funds drawn will be paid monthly, except that interest on loans based on the Eurodollar rate will be payable at the end of each Eurodollar interest period of one, two, three or six months, and in any event at least every three months. As a result of the defaults described below, the lenders may increase the interest rate accruing on the outstanding loans by 2.0% above the rate otherwise applicable as default interest.

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The Credit Facility matures on September 27, 2011, or December 27, 2012 in the event the Convertible Notes (defined below) are entirely converted into equity, with no remaining cash payment obligations, or are refinanced with a maturity date not earlier than June 27, 2013.

As of June 30, 2008, the Company was not in compliance with the financial and minimum average daily production covenants set forth in the Amended Credit Agreement. The Company is currently discussing a possible waiver or amendment to the Amended Credit Agreement with its lenders. However, absent a waiver or an amendment to the financial covenants or repayment or refinancing of the Credit Facility, it is likely that the Company will not be in compliance with the covenants for the next twelve months. Our lenders could accelerate our indebtedness under the Credit Facility and exercise any available rights and remedies. Our lenders could prevent us from paying interest to the holders of our Convertible Notes. The failure to make our scheduled interest payments or the acceleration of the indebtedness under the Amended Credit Agreement would result in a default of our Convertible Notes. Accordingly, the \$64.6 million outstanding under the Credit Facility at June 30, 2008 is classified as a current liability in the accompanying Consolidated Balance Sheet at June 30, 2008.

NOTE 7. CONVERTIBLE NOTES

On January 19, 2007, we entered into a Series A Note Purchase Agreement for the private placement of Series A Notes in a total aggregate principal amount of \$18.5 million and a Series B Note Purchase Agreement for the private placement the Series B Notes (together with the Series A Notes, the Convertible Notes) in a total aggregate principal amount of \$31.7 million. The Convertible Notes were bifurcated into two series because a shareholder vote was required for issuance of any Convertible Notes above the amount issued under the Series A Notes. The Series A Notes and the Series B Notes are convertible into our common shares at a price of \$1.17 per share, as may be adjusted in accordance with the terms of the Series A Notes or the Series B Notes (as applicable), and we may require the conversion of the Series A Notes or the Series B Notes (as applicable) at any time 18 months after the closing date of the applicable issuance that our common shares trade above \$2.05, as may be adjusted, for 20 days within a period of 30 consecutive trading days. On the day of the Series A Note Purchase Agreement and the Series B Note Purchase Agreement, the \$1.17 conversion price was at premium to our closing stock price of \$1.00.

On January 30, 2007, we closed the private placement of the Series A Notes. The Series A Notes mature on March 31, 2012, unless earlier converted, redeemed or repurchased. The Series A Notes bear interest at a rate of 9.25% per annum, commencing on January 30, 2007. Interest on the Series A Notes is payable quarterly in arrears on March 31, June 30, September 30 and December 31 of each year, beginning on June 30, 2007.

On March 29, 2007 our shareholders authorized the issuance of the underlying shares of the Series B Notes and on March 30, 2007, we closed the private placement of \$31.7 million of Series B Notes. The Series B Notes mature on March 31, 2012, unless earlier converted, redeemed or repurchased. The Series B Notes bear interest at a rate of 9.25% per annum, commencing on March 30, 2007. Interest on the Series B Notes is payable quarterly in arrears on March 31, June 30, September 30 and December 31 of each year, beginning on June 30, 2007.

As part of the private placements, we entered into a registration rights agreement (the Registration Rights Agreement) with the investors requiring us to file with the Securities and Exchange Commission (the SEC) registration statements covering the common shares issuable upon conversion of the Series A Notes and the Series B Notes. We have fulfilled our obligations under the Registration Rights Agreement to have an

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effective registration covering the shares that are issuable upon conversion of the Convertible Notes with respect to all of the shares underlying the Convertible Notes, with the exception of 123,932 common shares issuable upon conversion of Series B Notes held by certain of our officers and directors. The registration statements and the related prospectuses can be accessed via the SEC website at www.sec.gov.

NOTE 8. SHAREHOLDERS EQUITY

Outstanding Share Data

We have an unlimited number of authorized common shares, without par value, and an unlimited number of preferred shares which may be issued in series and with preferences as determined by our Board of Directors. As of the filing of this report no preferred shares had been issued.

At June 30, 2008, 81,278,549 common shares were issued and outstanding, 6,452,000 common share options outstanding and reserved for issuance under our Amended and Restated Share Option Plan (the Amended Option Plan) and 156,667 unvested restricted stock units (RSUs) outstanding under our Restricted Share Unit Plan. There were also 15,841,880 common shares reserved for issuance upon conversion of the Series A Notes and 27,059,829 common shares reserved for issuance upon conversion of the Series B Notes.

Basic and Diluted Loss per Share

Basic loss per share is computed by dividing the net loss available to common shareholders by the weighted average number of common shares outstanding during the period. The shares represented by vested RSUs issued to date are included in the calculation of the weighted average basic common shares outstanding. Diluted loss per share is calculated giving effect to the potential dilution that would occur if vested stock options, RSUs and stock purchase warrants were exercised and the Convertible Notes were converted to common shares. The dilutive effect of options, RSUs, warrants and the Convertible Notes is computed by application of the treasury stock method which assumes that proceeds from the exercise of in-the-money options and warrants would be used to repurchase common shares at average market prices during the period. Diluted amounts are not presented when the effects of the computations

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are anti-dilutive due to net losses incurred. Accordingly, there is no difference in the amounts presented for basic and diluted loss per share for the quarters ended June 30, 2008 and 2007. Listed below is a table showing the potentially dilutive shares outstanding as of June 30, 2008 and 2007 which have been excluded from the diluted earnings per share calculation.

	2008	June 30, 2007
Potentially Dilutive Shares Outstanding		
Options	6,452,000	4,760,000
Unvested RSUs	156,667	122,500
Series A Notes	15,841,880	15,841,880
Series B Notes	27,059,829	27,059,829
Warrants		4,649,569
Total potentially dilutive shares outstanding	49,510,376	52,433,778

Options and RSUs Issued and Outstanding

The Amended Option Plan and the Restricted Share Unit Plan (together, the Plans), both approved by our shareholders on June 21, 2007, authorizes the granting of incentive and nonqualified options to purchase up to 10,000,000 common shares in the aggregate. The Plans are administered by the Board of Directors which determines the terms pursuant to which any option is granted. The Plans provide that upon a change in control, options then outstanding will immediately vest and we will take such actions as are necessary to make all shares subject to options immediately salable and transferable.

Of the 10,000,000 shares authorized for issuance in the aggregate under the Plans, 9,945,620 shares have been granted and 1,506,974 shares have been forfeited, leaving a total of 1,561,354 shares available for issuance as of June 30, 2008. Below is a reconciliation of our remaining shares available to grant at the end of the second quarter 2008:

	June 30, 2008
Common Shares Available to Grant	
Common shares in treasury available to grant	10,000,000
Options granted	(9,352,000)
Options forfeited	1,445,000
RSUs granted	(593,620)
RSUs forfeited	61,974
Common shares available to grant as of June 30, 2008	1,561,354

	Number of Shares	Weighted Average Exercise Price (1)
Option Activity		
Options outstanding at December 31, 2007	4,550,000	\$ 1.91
Options granted	1,917,000	\$ 0.73
Options exercised		\$
Options expired/cancelled	(15,000)	\$
Options outstanding at June 30, 2008	6,452,000	\$ 1.56

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Options exercisable at June 30, 2008	4,316,659	\$	1.29
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(1) Exercise price is in Canadian dollars.

	Number of Shares
RSU Activity	
RSUs unvested at December 31, 2007	95,000
RSUs granted	304,870
RSUs vested	(191,229)
RSUs expired/cancelled	(51,974)
RSUs unvested at June 30, 2008	156,667

Share Based Payments Expensed for the six months ended June 2008 and 2007

SFAS No. 123(R), paragraph B129, "Equity Instruments with Exercise Prices Denominated in a Foreign Currency" requires that all equity instruments with exercise prices denominated in a currency other than the currency of the market in which the underlying equity instrument primarily trades be accounted for as liabilities. Because we have granted options that are priced in Canadian dollars, and our stock is primarily traded on the American Stock Exchange ("AMEX"), the liability method is required relative to all U.S. employees. We employ the following methods in recording share-based payments.

The liability method to account for options granted to U.S. employees in Canadian dollars. Under this method, we record a liability for vested options equal to the value of such vested options as calculated by the Black-Scholes model using the option exercise price and the fair value per share of the common stock underlying the option as of the *measurement date*.

The equity method to account for options granted to Canadian employees and options granted to U.S. employees in U.S. dollars. We calculate the expense under this method based on the Black-Scholes value of the option at the *date of the grant*. This expense is recorded in equal amounts as the options vest; typically over two years.

The fair value of share-based payments are expensed, with a corresponding increase to additional paid-in capital for the equity method, or the share-based payment liability for the liability method. Upon exercise of stock options, the consideration paid upon exercise is recorded as additional value of common shares and the amount previously recognized in additional paid-in capital is reclassified to common shares.

Both of the aforementioned methods of calculating share-based payments require us to make several estimates including when stock options might be exercised, the stock price volatility, forfeiture rates, and the model used to calculate value. The timing for exercise of options is outside our control and depends upon a variety of factors including the market value our common shares and the financial objectives of the holders of the options, among other factors. We calculate volatility using historical data; however, future volatility is inherently uncertain.

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The following table summarizes our share-based payments expense under each method:

In Thousands	Six Months Ended June 30,	
	2008	2007
Share-based payments expense under the liability method	\$ 205	\$ 1,189
Share-based payments expense under the equity method	412	1,189
Share-based payments expense	\$ 617	\$ 1,189

Stock Activity During the Quarter

304,870 restricted stock units and 115,000 stock options were issued to directors, employees and consultants. Grants to directors were in accordance with the Company's Director Compensation Policy. Employee and consultant grants were for services rendered during the current year.

NOTE 9. INCOME TAXES

The income tax benefit realized in the first six months of 2007 was \$1.3 million. This is a tax benefit that is passed on to our flow-through shareholders. In order to have this tax benefit, the flow-through shareholders pay a premium above market for their shares. This premium is reduced in equity and recorded as a liability. As the capital obligation is satisfied, the liability is reduced and an income tax benefit is recorded to the income statement. The liability no longer exists and no tax benefit was recognized in the first six months of 2008.

NOTE 10. OTHER COMPREHENSIVE LOSS

Comprehensive earnings (loss) is a term used to refer to net earnings plus other comprehensive income (loss). Other comprehensive income (loss) is comprised of revenues, expenses, gains, and losses that under generally accepted accounting principles are reported as separate components of shareholders' equity instead of net earnings. Items included in other comprehensive loss for the three and six months ended June 30, 2008 and 2007 are foreign currency gains (losses) related to the translation of the assets and liabilities of our Canadian operations and unrealized gains (losses) related to the changes in the fair value of derivative instruments designated as cash flow hedges.

Comprehensive loss for the three months and six months ended June 30, 2008 and 2007, respectively, is reflected in the table below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Net loss	\$ (4,694)	\$ (4,592)	\$ (8,337)	\$ (5,939)

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Effects of currency translation	413	2,654	(1,069)	2,966
Change in fair value of derivatives	(8,586)	231	(16,123)	(1,360)
Comprehensive loss	\$ (12,867)	\$ (1,707)	\$ (25,529)	\$ (4,333)

NOTE 11. SALES, TRANSPORTATION AND GATHERING COMMITMENTS

Sales Commitments

We had no forward sales contracts at June 30, 2008.

Firm Transportation Service Agreements

We have a firm transportation agreement in place through April 11, 2013 to transport gas from Cheyenne Plains to ANR PEPL (Oklahoma). The agreement obligates us to pay \$0.34 per Dth on 2,000 Dth/D or approximately \$20,000 per month. The firm commitment payment is offset by any charges for volumes shipped on the Cheyenne Plains pipeline to the ANR PEPL (Oklahoma) delivery hub. We released our 2,000 Dth/D capacity commitment for a period of eight months (from March 2008 through October 2008) at the full volume commitment for \$0.14 per Dth.

We also have a firm transportation agreement with an unaffiliated third party that expires November 30, 2013. The agreement requires us to pay \$0.15 per Dth on 100% load basis of 4,000 Dth/D. Gas is received at Glenrock, Wyoming and delivered to the Dullknife hub in Wyoming. We are currently meeting the volume commitment relative to this agreement.

Gathering Commitments

We have a fee-based gas gathering and compression services agreement with an unrelated third party for the provision of field

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gathering, treating, compression and high pressure transport of natural gas to be produced from our Fayetteville Shale project. We are obligated to deliver sufficient volumes to generate fees totaling \$19.0 million over a four-year period which began in April 2008.

NOTE 12. DIFFERENCES BETWEEN CANADIAN AND UNITED STATES ACCOUNTING PRINCIPLES

These financial statements have been prepared in accordance with U.S. GAAP which differ in certain respects with those principles and practices that we would have followed had our financial statements been prepared in accordance with Canadian GAAP.

Differences between U.S. GAAP and Canadian GAAP impact us as follows:

Oil and Gas Properties

Canadian GAAP requires recognition and measurement processes to assess impairment of oil and gas properties using estimates of future oil and gas prices and costs plus the cost of unproved properties that have been excluded from the depletion calculation. In the measurement of the impairment, the future net cash flows of a cost center's proved and probable reserves are discounted using a risk-free interest rate. For U.S. GAAP purposes, future net cash flows from proved reserves using period-end, non-escalated prices and costs, are discounted to present value at 10% per annum and compared to the carrying value of oil and gas properties.

Comprehensive Loss

U.S. GAAP requires disclosure of comprehensive loss which includes net loss under U.S. GAAP plus the change in cumulative translation adjustment and the unrealized gain or loss on future volumes we have hedged. We have volumes hedged through December 2010 creating a current difference between U.S. and Canadian GAAP because the hedge gain or loss amounts are recognized on a current basis in the statement of operations under Canadian GAAP. The concept of comprehensive loss did not come into effect until fiscal years beginning on or after October 1, 2006 for Canadian GAAP.

Flow-Through Shares

U.S. GAAP requires the stated capital on flow-through share issuances to be equal to the estimated fair market value of the shares on the date of issue. The difference between the gross proceeds received on the issuance of the shares and the estimated fair market value of the shares is recorded as a liability (the Premium) until the renunciation of expenditures has occurred. The full renunciation has occurred as of June 30, 2008 and there is no flow-through share liability.

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Under Canadian GAAP, the gross proceeds received on flow-through share issuances are initially recorded as share capital. When the expenditures are incurred and the tax deductions are renounced to subscribers, Canadian GAAP requires that the stated capital be reduced and that income tax benefits be recorded for the estimated future income taxes that were renounced. Under U.S. GAAP, the initial liability is adjusted to a deferred income tax liability and as a result of the recalculation of our deferred taxes, this amount is ultimately recorded as an income tax benefit.

Share-Based Payments

U.S. GAAP, under SFAS No. 123(R), paragraph B129, *Equity Instruments with Exercise Prices Denominated in a Foreign Currency*, requires that all equity instruments with exercise prices denominated in a currency other than the currency of the market in which the underlying equity instrument primarily trades be accounted for as liabilities. This is not applicable under Canadian GAAP.

The impact of the above differences on the financial statements is as follows:

Statement of Operations	Six Months Ended June 30,	
dollars in thousands, except per share	2008	2007
Net loss for the year per U.S. GAAP	\$ (8,337)	\$ (5,939)
Adjustment for depletion	(1,096)	
Adjustments for foreign exchange gain (loss)	(488)	883
Difference in recovery of future income tax asset		1,278
Net loss for the year per Canadian GAAP	\$ (9,921)	\$ (3,778)
Basic and diluted loss per share per Canadian GAAP	\$ (0.12)	\$ (0.05)
Weighted average number of shares outstanding per U.S. GAAP	81,151,150	80,816,505

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Balance Sheet dollars in thousands	June 30, 2008	December 31, 2007
Total assets per U.S. GAAP	\$ 154,778	\$ 132,566
Adjustment to asset for depletion	(1,602)	(506)
Adjustment to asset for impairment	25,000	25,000
Total assets per Canadian GAAP	\$ 178,176	\$ 157,060
Total liabilities per U.S. GAAP	\$ 154,541	\$ 107,187
Total liabilities per Canadian GAAP	\$ 154,541	\$ 107,187

Statement of Shareholders' Equity dollars in thousands	June 30, 2008	December 31, 2007
Cumulative deficit, end of the year, per U.S. GAAP	\$ (65,915)	\$ (57,578)
Adjustment for depletion	(1,602)	(506)
Adjustment for impairment	25,000	25,000
Difference in recovery of future income tax asset	(2,874)	(2,874)
Adjustment for tax effects of flow-through share liability	6,275	6,275
Cumulative foreign exchange adjustment	4,838	5,907
Deficit, end of the year, per Canadian GAAP	(34,278)	(23,776)
Recovery of future income tax asset	2,874	2,874
Adjustment for flow-through share liability		
Cumulative unrealized gain on hedges	(14,547)	1,576
Adjustment for tax effects of flow-through share liability	(6,275)	(6,275)
Share capital, share subscriptions and contributed surplus, other comprehensive income per Canadian and U.S. GAAP	75,862	75,474
Stockholders' equity per Canadian GAAP	\$ 23,636	\$ 49,873
Stockholders' equity per U.S. GAAP	\$ 238	\$ 25,379

Statement of Cash Flows dollars in thousands	Six Months Ended June 30,	
	2008	2007
Cash flows from operating activities per U.S. GAAP	\$ 1,370	\$ (7,024)
Difference in recovery of future income tax asset		(1,278)
Cash flows from operating activities per Canadian GAAP	1,370	(8,302)
Cash flows from financing activities per U.S. GAAP	21,569	34,274
Difference in recovery of future income tax asset		1,278
Cash flows from financing activities per Canadian GAAP	21,569	35,552
Cash flows from investing activities per U.S. GAAP	(21,516)	(32,417)
Cash flows from investing activities per Canadian GAAP	(21,516)	(32,417)
Effect of foreign exchange on cash flows	(488)	883
Increase (decrease) in cash per U.S. GAAP and Canadian GAAP	\$ 935	\$ (4,284)

NOTE 13. RELATED PARTY TRANSACTIONS

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We paid \$75,563 in the first six months of 2008 for legal fees to a law firm of which one of our directors is a partner. At June 30, 2008 \$32,377 was outstanding and payable to this law firm.

All past and future and ongoing transactions with affiliates are and will be on terms which management believes are no less favorable than could be obtained from non-affiliated parties.

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

Unless the context otherwise requires, the terms "Storm Cat," "we," "us," "our" and the "Company," when used herein refer to Storm Cat Energy Corporation, together with its operating subsidiaries. When the context requires, we refer to these entities separately. The following Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company should be read in conjunction with the Consolidated Financial Statements and notes related thereto included in this Quarterly Report on Form 10-Q.

Results of Operations

Comparative Results of Operations for the three and six months ended June 30, 2008 and 2007, respectively.

The following table sets forth selected operating data for the three months ended June 30, 2008 (the "Q2 2008 Period"), and the three months ended June 30, 2007 (the "Q2 2007 Period"):

Selected Operating Data:	Three Months Ended June 30,			% Change
	2008	2007	Change	
Wells drilled in period	17	18	(1)	(5.6)%
Producing wells at end of period	464	355	109	30.7%
Net natural gas sales volume (MMcf)	1,151.4	745.8	405.6	54.4%
Natural gas revenue (<i>In Thousands</i>)				
Natural gas sales	\$ 8,193	\$ 2,273	\$ 5,920	260.4%
Natural gas derivatives realized gains (losses)	\$ (1,643)	\$ 1,395	\$ (3,038)	