

CREDO PETROLEUM CORP
Form 10-Q
September 15, 2008
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended July 31, 2008

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

For the transition period from _____ to _____

Commission File Number: 0-8877

CREDO PETROLEUM CORPORATION

(Exact name of registrant as specified in its charter)

Edgar Filing: CREDO PETROLEUM CORP - Form 10-Q

Colorado
(State or other jurisdiction of incorporation or organization)

84-0772991
(IRS Employer Identification No.)

1801 Broadway, Suite 900, Denver, Colorado
(Address of principal executive offices)

80202
(Zip Code)

303-297-2200

(Registrant's telephone number, including area code)

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a 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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, net of treasury stock, as of the latest practicable date.

| Date | Class | Outstanding |
|----------------|-------------------------------|-------------|
| Sept. 15, 2008 | Common stock, \$.10 par value | 10,507,000 |

Table of Contents

EXPLANATORY NOTE

On September 2, 2008, in connection with preparing its quarterly report for third quarter 2008, management of CREDO Petroleum Corporation (the company) and the Audit Committee of its Board of Directors determined that the contemporaneous formal documentation it had historically prepared to support its initial hedge designations in connection with the company's natural gas hedging program does not meet the technical requirements to qualify for cash flow hedge accounting treatment in accordance with SFAS 133. The primary reason for this determination was that the formal hedge documentation lacks specificity of the hedged items and therefore, the cash flow designations failed to meet hedge documentation requirements for cash flow hedge accounting treatment. Consequently, the unrealized gain or loss should have been recorded in the consolidated statements of operations as a component of income before income taxes. Under the cash flow accounting treatment used by the company, the fair values of the hedge contracts was recognized in the consolidated balance sheets with the resulting unrealized gain or loss, net of income taxes, recorded initially in accumulated other comprehensive income and later reclassified through earnings when the hedged production affected earnings.

The company will restate its consolidated financial statements for fiscal years ended October 31, 2005, 2006, 2007 and the first and second quarters of fiscal year ending October 31, 2008. There is no effect in any period on overall cash flows, EBITDA, total assets, total liabilities or total stockholders' equity. The restatement did not have any impact on any of the Company's financial covenants under its line of credit. Details of the effect of the restatement are indicated in Note 1 to the Consolidated Financial Statements.

Table of Contents

CREDO PETROLEUM CORPORATION AND SUBSIDIARIES

Quarterly Report on Form 10-Q For the Period Ended July 31, 2008

TABLE OF CONTENTS

| | Page No. |
|--|--|
| <u>PART I - FINANCIAL INFORMATION</u> | |
| <u>Item 1.</u> | <u>Financial Statements</u> |
| <u>Consolidated Balance Sheets</u> <u>As of July 31, 2008 (Unaudited) and October 31, 2007</u> | 4 |
| <u>Consolidated Statements of Operations</u> <u>For the Three and Nine Months Ended July 31, 2008 and 2007 (Unaudited)</u> | 5 |
| <u>Consolidated Statement of Stockholders' Equity and Comprehensive Income</u> <u>For the Nine Months Ended July 31, 2008 (Unaudited)</u> | 6 |
| <u>Consolidated Statements of Cash Flows</u> <u>For the Nine Months Ended July 31, 2008 and 2007 (Unaudited)</u> | 7 |
| <u>Notes to Consolidated Financial Statements (Unaudited)</u> | 8 |
| <u>Item 2.</u> | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> |
| | 14 |
| <u>Item 3.</u> | <u>Quantitative and Qualitative Disclosures About Market Risk</u> |
| | 23 |
| <u>Item 4.</u> | <u>Controls and Procedures</u> |
| | 24 |
| <u>PART II - OTHER INFORMATION</u> | |
| <u>Item 1.</u> | <u>Legal Proceedings</u> |
| | 24 |
| <u>Item 1A.</u> | <u>Risk Factors</u> |
| | 24 |
| <u>Item 2.</u> | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> |
| | 24 |
| <u>Item 3.</u> | <u>Defaults Upon Senior Securities</u> |
| | 24 |
| <u>Item 4.</u> | <u>Submission of Matters to a Vote of Security Holders</u> |
| | 25 |
| <u>Item 5.</u> | <u>Other Information</u> |
| | 25 |
| <u>Item 6.</u> | <u>Exhibits</u> |
| | 25 |

The terms CREDO , Company , we , our , and us refer to CREDO Petroleum Corporation and its subsidiaries unless the context suggests otherwise.

Table of Contents**PART I - FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****CREDO PETROLEUM CORPORATION AND SUBSIDIARIES****Consolidated Balance Sheets**

| | July 31, 2008 (Unaudited) | October 31, 2007 (Restated) |
|--|---------------------------------|-----------------------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 23,795,000 | \$ 7,285,000 |
| Short-term investments | 3,595,000 | 6,383,000 |
| Receivables: | | |
| Accrued oil and gas sales | 3,423,000 | 1,647,000 |
| Trade | 580,000 | 602,000 |
| Derivative Assets | | 443,000 |
| Other current assets | 63,000 | 55,000 |
| Total current assets | 31,456,000 | 16,415,000 |
| Long-term assets: | | |
| Oil and gas properties, at cost, using full cost method: | | |
| Unevaluated oil and gas properties | 11,427,000 | 7,791,000 |
| Evaluated oil and gas properties | 55,258,000 | 51,691,000 |
| Less: accumulated depreciation, depletion and amortization of oil and gas properties | (24,616,000) | (22,108,000) |
| Net oil and gas properties, at cost, using full cost method | 42,069,000 | 37,374,000 |
| Exclusive license agreement, net of amortization of \$553,000 in 2008 and \$501,000 in 2007 | 146,000 | 198,000 |
| Compressor and tubular inventory to be used in development | 2,478,000 | 1,090,000 |
| Other, net | 344,000 | 272,000 |
| Total assets | \$ 76,493,000 | \$ 55,349,000 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$ 882,000 | \$ 1,639,000 |
| Revenue distribution payable | 1,493,000 | 979,000 |
| Derivative liabilities | 673,000 | |
| Other accrued liabilities | 506,000 | 852,000 |
| Income taxes payable | 472,000 | 434,000 |
| Total current liabilities | 4,026,000 | 3,904,000 |
| Long Term Liabilities: | | |
| Deferred income taxes, net | 10,374,000 | 9,204,000 |
| Derivative liabilities due in more than one year | 193,000 | |
| Exclusive license obligation, less current obligations of \$77,000 in 2008 and 2007 | 85,000 | 85,000 |

Edgar Filing: CREDO PETROLEUM CORP - Form 10-Q

| | | |
|---|----------------------|---------------|
| Asset retirement obligation | 1,118,000 | 1,016,000 |
| Total liabilities | 15,796,000 | 14,209,000 |
| Stockholders' Equity: | | |
| Preferred stock, no par value, 5,000,000 shares authorized, none issued | | |
| Common stock, \$.10 par value, 20,000,000 shares authorized, 10,660,000 shares issued in 2008 and 9,510,000 in 2007 | 1,066,000 | 951,000 |
| Capital in excess of par value | 31,174,000 | 15,913,000 |
| Treasury stock at cost, 153,000 shares in 2008 and 215,000 in 2007 | (361,000) | (506,000) |
| Retained earnings | 28,818,000 | 24,782,000 |
| Total stockholders' equity | 60,697,000 | 41,140,000 |
| Total liabilities and stockholders' equity | \$ 76,493,000 | \$ 55,349,000 |

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

Table of Contents**CREDO PETROLEUM CORPORATION AND SUBSIDIARIES****Consolidated Statements of Operations****(Unaudited)**

| | Nine Months Ended July 31, | | Three Months Ended July 31, | |
|---|-------------------------------|---------------------|--------------------------------|---------------------|
| | 2008 | 2007 (Restated) | 2008 | 2007 (Restated) |
| REVENUES: | | | | |
| Oil and gas sales | \$ 14,321,000 | \$ 11,121,000 | \$ 5,646,000 | \$ 3,613,000 |
| Investment income and other | 125,000 | 685,000 | 49,000 | 233,000 |
| | 14,446,000 | 11,806,000 | 5,695,000 | 3,846,000 |
| COSTS AND EXPENSES: | | | | |
| Oil and gas production | 2,883,000 | 2,546,000 | 1,045,000 | 837,000 |
| Depreciation, depletion and amortization | 2,594,000 | 2,782,000 | 843,000 | 883,000 |
| General and administrative | 1,034,000 | 1,020,000 | 337,000 | 376,000 |
| Interest | 7,000 | 20,000 | 2,000 | 6,000 |
| | 6,518,000 | 6,368,000 | 2,227,000 | 2,102,000 |
| INCOME FROM OPERATIONS | 7,928,000 | 5,438,000 | 3,468,000 | 1,744,000 |
| GAIN (LOSS) ON DERIVATIVE CONTRACTS | | | | |
| Realized gains (losses) from derivative contracts | (1,024,000) | 1,187,000 | (1,876,000) | 201,000 |
| Unrealized gains (losses) from derivative contracts | (1,309,000) | 423,000 | 3,015,000 | 1,466,000 |
| | (2,333,000) | 1,610,000 | 1,139,000 | 1,667,000 |
| INCOME BEFORE INCOME TAXES | 5,595,000 | 7,048,000 | 4,607,000 | 3,411,000 |
| INCOME TAXES | (1,559,000) | (2,010,000) | (1,264,000) | (964,000) |
| NET INCOME | \$ 4,036,000 | \$ 5,038,000 | \$ 3,343,000 | \$ 2,447,000 |
| EARNINGS PER SHARE OF COMMON STOCK | | | | |
| BASIC | \$.43 | \$.54 | \$.35 | \$.26 |
| EARNINGS PER SHARE OF COMMON STOCK | | | | |
| DILUTED | \$.42 | \$.54 | \$.34 | \$.26 |
| Weighted average number of shares of Common Stock and dilutive securities: | | | | |
| Basic | 9,430,000 | 9,268,000 | 9,690,000 | 9,282,000 |
| Diluted | 9,509,000 | 9,402,000 | 9,772,000 | 9,406,000 |

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

Table of Contents**CREDO PETROLEUM CORPORATION AND SUBSIDIARIES****Statement of Stockholders' Equity and Comprehensive Income****(Unaudited)**

For the Nine Months Ended July 31, 2008

| | Common Stock | | Capital In | Treasury | Retained | Total |
|---|--------------|--------------|---------------|--------------|---------------|---------------|
| | Shares | Amount | Excess Of | Stock | Earnings | Stockholders |
| | | | Par Value | | | Equity |
| Balance, October 31, 2007 | | | | | | |
| Restated | 9,510,000 | \$ 951,000 | \$ 15,913,000 | \$ (506,000) | \$ 24,782,000 | \$ 41,140,000 |
| Comprehensive income: | | | | | | |
| Net income | | | | | 4,036,000 | 4,036,000 |
| Sale of Common Stock | 1,150,000 | 115,000 | 14,996,000 | | | 15,111,000 |
| Exercise of common stock options | | | 221,000 | 145,000 | | 366,000 |
| Compensation expense associated with unvested portion of previously granted stock options | | | 44,000 | | | 44,000 |
| Balance, July 31, 2008 | 10,660,000 | \$ 1,066,000 | \$ 31,174,000 | \$ (361,000) | \$ 28,818,000 | \$ 60,697,000 |

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

Table of Contents**CREDO PETROLEUM CORPORATION AND SUBSIDIARIES****Consolidated Statements of Cash Flows****(Unaudited)**

| | Nine Months Ended July 31, | |
|---|-------------------------------|--------------------|
| | 2008 | 2007 (Restated) |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 4,036,000 | \$ 5,038,000 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation, depletion and amortization | 2,594,000 | 2,782,000 |
| Unrealized (gains) loss on derivative contracts | 1,309,000 | (423,000) |
| Deferred income taxes | 1,170,000 | 1,566,000 |
| Compensation expense related to stock options granted | 44,000 | 138,000 |
| Other | 38,000 | 62,000 |
| Changes in operating assets and liabilities: | | |
| (Gain) loss on short term investments | 67,000 | |
| Proceeds from short-term investments | 2,721,000 | 1,492,000 |
| Purchase of short-term investments | | (2,169,000) |
| Accrued oil and gas sales | (1,776,000) | 180,000 |
| Trade receivables | 22,000 | 371,000 |
| Other current assets | (8,000) | (158,000) |
| Accounts payable and accrued liabilities | (589,000) | (831,000) |
| Income taxes payable | 38,000 | 226,000 |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 9,666,000 | 8,274,000 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Additions to oil and gas properties | (8,414,000) | (6,794,000) |
| Proceeds from sale of oil and gas properties | 1,275,000 | 171,000 |
| Changes in other long-term assets | (1,494,000) | 202,000 |
| NET CASH USED IN INVESTING ACTIVITIES | (8,633,000) | (6,421,000) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Sale of common stock | 15,111,000 | |
| Proceeds from exercise of stock options (62,000 options in 2008 and 67,000 options in 2007) | 366,000 | 272,000 |
| NET CASH PROVIDED BY FINANCING ACTIVITIES | 15,477,000 | 272,000 |
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 16,510,000 | 2,125,000 |
| CASH AND CASH EQUIVALENTS: | | |
| Beginning of period | 7,285,000 | 4,577,000 |
| End of period | \$ 23,795,000 | \$ 6,702,000 |
| Supplemental cash flow information: | | |
| Cash paid during the period for income taxes | \$ 352,000 | \$ 207,000 |
| Additions to oil & gas properties in current liabilities | \$ 383,000 | |

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

Table of Contents

CREDO PETROLEUM CORPORATION AND SUBSIDIARIES

Notes To Consolidated Financial Statements (Unaudited)

July 31, 2008

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with U. S. generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U. S. generally accepted accounting principles for complete financial statements. In the opinion of management, the consolidated financial statements contain all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the company's results for the periods presented. These consolidated financial statements should be read in conjunction with the company's Annual Report on Form 10-K/A for the fiscal year ended October 31, 2007.

On September 2, 2008, in connection with preparing its quarterly report for third quarter 2008, management of CREDO Petroleum Corporation (the company) and the Audit Committee of its Board of Directors determined that the contemporaneous formal documentation it had historically prepared to support its initial hedge designations in connection with the company's natural gas hedging program does not meet the technical requirements to qualify for cash flow hedge accounting treatment in accordance with SFAS 133. The primary reason for this determination was that the formal hedge documentation lacks specificity of the hedged items and therefore, the cash flow designations failed to meet hedge documentation requirements for cash flow hedge accounting treatment. Consequently, the unrealized gain or loss should have been recorded in the consolidated statements of operations as a component of income before income taxes. Under the cash flow accounting treatment used by the company, the fair values of the hedge contracts was recognized in the consolidated balance sheets with the resulting unrealized gain or loss, net of income taxes, recorded initially in accumulated other comprehensive income and later reclassified through earnings when the hedged production affected earnings.

The company will restate its consolidated financial statements for fiscal years ended October 31, 2005, 2006, 2007 and the first and second quarters of fiscal year ending October 31, 2008. There is no effect in any period on overall cash flows, EBITDA, total assets, total liabilities or total stockholders' equity. The cumulative effect on all periods of the restatement and the correction to the third quarter of 2008 was to reduce net income by \$182,000 and diluted income per share by \$.03. For the three years ended October 31, 2007, the cumulative effect of the restatement was to increase net income by \$756,000 and to increase diluted income per share by \$.08. For the nine months ended July 31, 2008, the cumulative effect of the restatement and the correction to third quarter 2008 income was to reduce net income by \$938,000 and to reduce diluted income per share by \$.11. The restatement did not have any impact on any of the Company's financial covenants under its line of credit. The primary financial statement items impacted by this restatement are indicated below:

Table of Contents**Consolidated Statements of Operations**

| | Nine Months Ended July 31, 2007 | | Three Months Ended July 31, 2007 | |
|---|---------------------------------|-------------|----------------------------------|-----------|
| | As Previously Reported | Restated | As Previously Reported | Restated |
| Oil & Gas Sales | 12,308,000 | 11,121,000 | 3,814,000 | 3,613,000 |
| Total Revenues | 12,993,000 | 11,806,000 | 4,047,000 | 3,846,000 |
| Income from Operations | 6,625,000 | 5,438,000 | 1,945,000 | 1,744,000 |
| Realized Gains (Losses) from derivative contracts | | 1,187,000 | | 201,000 |
| Unrealized Gains (Losses) from derivative contracts | | 423,000 | | 1,466,000 |
| Income Before Taxes | 6,625,000 | 7,048,000 | 1,945,000 | 3,411,000 |
| Income Taxes | (1,888,000) | (2,010,000) | (554,000) | (964,000) |
| Net Income | 4,737,000 | 5,038,000 | 1,391,000 | 2,447,000 |
| Earnings per share - | | | | |
| Basic | \$ 0.51 | \$ 0.54 | \$ 0.15 | \$ 0.26 |
| Diluted | \$ 0.50 | \$ 0.54 | \$ 0.15 | \$ 0.26 |

Consolidated Statements of Cash Flows

| | July 31, 2007 | |
|---|------------------------|-----------|
| | As Previously Reported | Restated |
| Cash Flows from Operating Activities | | |
| Net Income | 4,737,000 | 5,038,000 |
| Unrealized gains on derivative contracts | | (423,000) |
| Changes in operating assets and liabilities | | |
| Other current assets | (281,000) | (158,000) |

2. SIGNIFICANT ACCOUNTING POLICIES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The company bases its estimates on historical experience and on various other assumptions it believes to be reasonable under the circumstances. Although actual results may differ from these estimates under different assumptions or conditions, the company believes that its estimates are reasonable and that actual results will not vary significantly from the estimated amounts.

The company recognizes all derivatives as fair value hedges on its balance sheet at fair value at the end of each period. Changes in the fair value of hedges are now recorded in the Consolidated Statement of Operations

3.

STOCK-BASED COMPENSATION

Edgar Filing: CREDO PETROLEUM CORP - Form 10-Q

The CREDO Petroleum Corporation 2007 Stock Option Plan (the 2007 Plan) is described in the Notes to

Edgar Filing: CREDO PETROLEUM CORP - Form 10-Q

Table of Contents

Consolidated Financial Statements in the company's Annual Report on Form 10-K/A for the year ended October 31, 2007. No options have been granted under the 2007 Plan. The CREDO Petroleum Corporation 1997 Stock Option Plan (the 1997 Plan) expired on July 29, 2007. No additional options can be granted under the 1997 Plan. However, all outstanding options granted under the 1997 Plan will continue to be governed by the terms of that Plan.

For the nine months ended July 31, 2008 and 2007, the company recognized stock based compensation expense of \$44,000 and \$138,000 respectively. For the three months ended July 31, 2008 and 2007, the company recognized compensation expense of \$14,000 and \$28,000, respectively. The estimated unrecognized compensation cost from unvested stock options as of July 31, 2008 was approximately \$79,000 which is expected to be recognized over an average of 2 years.

No options were granted during the nine months ended July 31, 2008 and the fair value of the 40,000 options granted during the nine months ended July 31, 2007 was estimated on the date of grant using a Black-Scholes option pricing model. The weighted average assumptions used in the option pricing model for the nine months ended July 31, 2007 were: volatility, 50.84%; expected option term, 2.5 years; risk-free interest rate, 4.58%; and expected dividend yield, 0%.

Plan activity for the nine months ended July 31, 2008 is set forth below:

| | Nine Months Ended July 31, 2008 | | |
|---|---------------------------------|--|---------------------------------|
| | Number of Options | Weighted Average Exercise Price | Aggregate Intrinsic Value |
| Outstanding at October 31, 2007 | 270,251 | \$ 6.94 | 642,000 |
| Granted | | | |
| Exercised | (61,938) | 5.93 | 407,000 |
| Cancelled or forfeited | | | |
| Outstanding at July 31, 2008 | 208,313 | \$ 7.25 | 490,000 |
| Exercisable at July 31, 2008 | 186,697 | \$ 6.60 | 599,000 |
| Weighted average contractual life at July 31, 2008 | | 5.54 years | |
| Weighted average market price at date of exercise for options exercised | | \$ 12.50 | |

The following table summarizes information about stock options currently outstanding and exercisable at July 31, 2008:

| Range of Exercise Prices | Number Outstanding at July 31, 2007 | Outstanding Weighted Average Remaining Contractual Life in Years | Weighted Average Exercise Price | Exercisable | |
|--------------------------------|--|--|--|--|---------------------------------------|
| | | | | Number Exercisable at July 31, 2008 | Weighted Average Exercise Price |
| \$5.93 | 168,313 | 4.87 | \$ 5.93 | 168,313 | \$ 5.93 |
| \$12.78 | 40,000 | 8.35 | \$ 12.78 | 18,334 | \$ 12.78 |

Edgar Filing: CREDO PETROLEUM CORP - Form 10-Q

\$5.93 - \$12.78

208,313

5.54

\$

7.25

186,647

\$

6.60

Table of Contents

4. NATURAL GAS PRICE HEDGING

On September 2, 2008, in connection with preparing its quarterly report for third quarter 2008, management of CREDO Petroleum Corporation (the company) and the Audit Committee of its Board of Directors determined that the contemporaneous formal documentation it had historically prepared to support its initial hedge designations in connection with the company's natural gas hedging program does not meet the technical requirements to qualify for cash flow hedge accounting treatment in accordance with SFAS 133. The primary reason for this determination was that the formal hedge documentation lacks specificity of the hedged items and therefore, the cash flow designations failed to meet hedge documentation requirements for cash flow hedge accounting treatment. Consequently, the unrealized gain or loss should have been recorded in the consolidated statements of operations as a component of income before income taxes. Under the cash flow accounting treatment used by the company, the fair values of the hedge contracts was recognized in the consolidated balance sheets with the resulting unrealized gain or loss, net of income taxes, recorded initially in accumulated other comprehensive income and later reclassified through earnings when the hedged production affected earnings.

The company periodically hedges the price of a portion of its estimated natural gas production when the potential for significant downward price movement is anticipated. Hedging transactions typically take the form of forward short positions and collars on the NYMEX futures market, and are closed by purchasing offsetting positions. Such hedges do not exceed estimated production volumes, are expected to have reasonable correlation between price movements in the futures market and the cash markets where the company's production is located, and are authorized by the company's Board of Directors. Hedges are expected to be closed as related production occurs but may be closed earlier if the anticipated downward price movement occurs or if the company believes that the potential for such movement has abated.

The company recognizes all derivatives as fair value hedges on its balance sheet at fair value at the end of each period. Changes in the fair value of hedges are now recorded in the Consolidated Statement of Operations.

Open hedge contracts are indexed to the NYMEX. Periodically, the company enters into contracts indexed to Panhandle Eastern Pipeline Company for Texas, Oklahoma mainline. For comparative purposes, hedges indexed to Panhandle Eastern Pipeline Company are expressed on a NYMEX basis. For hedges indexed to Panhandle Eastern Pipeline Company, the individual month price (basis) differentials between the NYMEX and Panhandle Eastern Pipeline Company range from minus \$1.45 in the winter months to minus \$0.90 in the spring months.

For the quarter ended July 31, 2008 the company has realized hedging losses of \$1,876,000 and unrealized hedging gains of \$3,015,000. Realized hedging gains were \$201,000 and unrealized hedging gains were \$1,466,000 for the same period in 2007.

For the nine months ended July 31, 2008 the company has realized hedging losses of \$1,024,000 and unrealized hedging losses of \$1,309,000. For the nine months ended July 31, 2007 the company had realized hedging gains of \$1,187,000 and unrealized gains of \$423,000.

The company has a hedging line of credit with its bank which is available, at the discretion of the company, to meet margin calls. To date, the company has not used this facility and maintains it only as a precaution related to possible margin calls. The maximum credit line is \$5,900,000 with interest calculated at the prime rate. The facility is unsecured and has covenants that require the company to maintain \$3,000,000 in cash or short term investments, none of which are required to be maintained at the company's bank, and prohibits funded debt in excess of \$500,000. It expires on November 15, 2010.

Table of Contents**5. EARNINGS PER SHARE**

The company's calculation of earnings per share of common stock is as follows:

| | 2008 | | Nine Months Ended July 31, | | 2007 (Restated) | |
|--|---------------|-----------|----------------------------|---------------|--------------------|----------------------------|
| | Net Income | Shares | Net Income Per Share | Net Income | Shares | Net Income Per Share |
| Basic earnings per share | \$ 4,036,000 | 9,430,000 | \$.43 | \$ 5,038,000 | 9,268,000 | \$.54 |
| Effect of dilutive shares of common stock from stock options | | 79,000 | (.01) | | 134,000 | |
| Diluted earnings per share | \$ 4,036,000 | 9,509,000 | \$.42 | \$ 5,038,000 | 9,402,000 | \$.54 |

| | 2008 | | Three Months Ended July 31, | | 2007 (Restated) | |
|--|---------------|-----------|-----------------------------|---------------|--------------------|----------------------------|
| | Net Income | Shares | Net Income Per Share | Net Income | Shares | Net Income Per Share |
| Basic earnings per share | \$ 3,343,000 | 9,690,000 | \$.35 | \$ 2,447,000 | 9,282,000 | \$.26 |
| Effect of dilutive shares of common stock from stock options | | 82,000 | (.01) | | 124,000 | |
| Diluted earnings per share | \$ 3,343,000 | 9,772,000 | \$.34 | \$ 2,447,000 | 9,406,000 | \$.26 |

6. INCOME TAXES

The company uses the asset and liability method of accounting for deferred income taxes. Deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities. Deferred tax assets or liabilities at the end of each period are determined using the tax rate in effect at that time.

The total future deferred income tax liability is extremely complicated for any energy company to estimate due in part to the long-lived nature of depleting oil and gas reserves and variables such as product prices. Accordingly, the liability is subject to continual recalculation, revision of the numerous estimates required, and may change significantly in the event of such things as major acquisitions, divestitures, product price changes, changes in reserve estimates, changes in reserve lives, and changes in tax rates or tax laws.

Edgar Filing: CREDO PETROLEUM CORP - Form 10-Q

On November 1, 2007 the company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). In implementing FIN 48, we found no significant uncertain tax positions. Our policy is to recognize potential accrued interest and penalties related to unrecognized tax benefits in income tax expense, which is consistent with the recognition of these items in prior reporting periods. No interest and penalties related to uncertain tax positions were accrued at July 31, 2008.

We have not had any material changes to our unrecognized tax benefits since adoption, nor do we anticipate significant changes to the total amount of unrecognized tax benefits within the next twelve months.

Table of Contents

As of July 31, 2008 we remain subject to examination of our Federal and state tax returns, except Colorado, for the tax years 2004 through 2006, and for the tax years 2003 through 2006 for our Colorado tax returns.

7. COMMITMENTS AND CONTINGENCIES

The company has been named as a defendant in a lawsuit alleging breach of contract, and other issues, arising in the normal course of its oil and gas activities. The company believes that a contractual agreement requires that disputes be resolved by arbitration. Although the company believes the allegations are without merit and that the company will ultimately prevail, the ultimate outcome of this lawsuit, or arbitration, cannot be determined at this time.

The company has no material outstanding commitments at July 31, 2008.

8. STOCK SALE

During the quarter ended July 31, 2008 the company entered into, and closed, a Company Stock Purchase Agreement with RCH Energy Opportunity Fund II, LP (RCH). Under the terms of the agreement the company sold to RCH 1,150,000 shares of newly-issued common stock, par value \$0.10 at a price of \$14.50 per share, in cash. Transaction fees paid from the proceeds of sale were \$1,564,000.

Also under the terms of the agreement, RCH nominated, and the company's Board of Directors elected, two new directors to serve on the company's Board of Directors for so long as RCH beneficially owns at least 15% of the company's outstanding stock and one director for so long as RCH beneficially owns at least 10% of the company's outstanding stock.

The Purchase Agreement contains a standstill provision that prohibits RCH from acquiring any additional shares of the company's stock for a period of two years without the consent of the company.

In connection with the Company Stock Purchase Agreement with RCH the company amended its Rights Agreement, dated as of April 11, 1989, as amended, in order to exempt the Purchase Agreement from application of the Rights Agreement.

9. RECENT ACCOUNTING PRONOUNCEMENTS

Edgar Filing: CREDO PETROLEUM CORP - Form 10-Q

In November 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combination* (FAS 141(R)) and SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51* (FAS 160). FAS 141(R) will change how business acquisitions are accounted for and will impact financial statements both on the acquisition date and in subsequent periods. FAS 160 will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity. FAS 141(R) and FAS 160 are effective for both public and private companies for fiscal years beginning on or after December 15, 2008 (fiscal 2010 for the company). FAS 141(R) will be applied prospectively. FAS 160 requires retroactive adoption of the presentation and disclosure requirements for existing minority interests. All other requirements of FAS 160 will be applied prospectively. Early adoption is prohibited for both standards. Management is currently evaluating the requirements of FAS 141(R) and FAS 160 and has not yet determined the impact on its financial statements.

In December 2007, the FASB issued SFAS No. 157, *Fair Value Measurements*. This Statement does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. However, the application of this Statement may change how fair value is determined. The Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within

Table of Contents

those fiscal years. As of December 1, 2007 the FASB has proposed a one-year deferral for the implementation of the Statement for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. Management is currently evaluating the requirements of FAS 157 and has not yet determined the impact on its financial statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an Amendment to FASB Statement No. 133*. This statement expands the disclosures, and form of disclosures, that must be presented regarding derivatives and hedging activities. The Statement is effective for financial statements issued for fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. Management is currently evaluating the requirements of FAS 161 and has not yet determined the impact on its financial statements.

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

EXPLANATORY NOTE

On September 2, 2008, in connection with preparing its quarterly report for third quarter 2008, management of CREDO Petroleum Corporation (the "company") and the Audit Committee of its Board of Directors determined that the contemporaneous formal documentation it had historically prepared to support its initial hedge designations in connection with the company's natural gas hedging program does not meet the technical requirements to qualify for cash flow hedge accounting treatment in accordance with SFAS 133. The primary reason for this determination was that the formal hedge documentation lacks specificity of the hedged items and therefore, the cash flow designations failed to meet hedge documentation requirements for cash flow hedge accounting treatment. Consequently, the unrealized gain or loss should have been recorded in the consolidated statements of operations as a component of income before income taxes. Under the cash flow accounting treatment used by the company, the fair values of the hedge contracts was recognized in the consolidated balance sheets with the resulting unrealized gain or loss, net of income taxes, recorded initially in accumulated other comprehensive income and later reclassified through earnings when the hedged production affected earnings.

The company will restate its consolidated financial statements for fiscal years ended October 31, 2005, 2006, 2007 and the first and second quarters of fiscal year ending October 31, 2008. There is no effect in any period on overall cash flows, EBITDA, total assets, total liabilities or total stockholders' equity. The restatement did not have any impact on any of the Company's financial covenants under its line of credit. Details of the effect of the restatement are indicated in Note 1 to the Consolidated Financial Statements.

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q includes certain statements that may be deemed to be "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. All statements included in this Quarterly Report on Form 10-Q, other than statements of historical facts, address matters that the company reasonably expects, believes or anticipates will or may occur in the future. Forward-looking statements may relate to, among other things:

- the company's future financial position, including working capital and anticipated cash flow;

- amounts and nature of future capital expenditures;
- operating costs and other expenses;
- wells to be drilled or reworked;
- oil and natural gas prices and demand;
- existing fields, wells and prospects;
- diversification of exploration;

Table of Contents

- estimates of proved oil and natural gas reserves;
- reserve potential;
- development and drilling potential;
- expansion and other development trends in the oil and natural gas industry;
- the company's business strategy;
- production of oil and natural gas;
- matters related to the Calliope Gas Recovery System;
- effects of federal, state and local regulation;
- insurance coverage;
- employee relations;
- investment strategy and risk; and
- expansion and growth of the company's business and operations.

LIQUIDITY AND CAPITAL RESOURCES

At July 31, 2008, working capital increased \$13,920,000, or 103% to \$27,430,000 compared to \$13,510,000 at July 31, 2007. For the nine months ended July 31, 2008, net cash provided by operating activities increased \$1,392,000 to \$9,666,000 compared to net cash provided by operating activities of \$8,274,000 for the same period in 2007. Net income decreased \$1,002,000 primarily due to the recognition of unrealized hedging losses.

For the nine months ended July 31, 2008 and 2007, net cash used in investing activities was \$8,633,000 and \$6,421,000, respectively. Investing activities primarily included oil and gas exploration and development expenditures, including Calliope, totaling \$8,414,000 and \$6,794,000 respectively.

During the quarter ended July 31, 2008, the company sold 1,150,000 shares of newly issued \$.10 par value common stock. The sales price was \$14.50 per share, resulting in gross proceeds of \$16,675,000. Transaction fees of \$1,564,000 were paid from the proceeds. The company also purchased joint interest holders' rights to future Calliope installation revenues for \$975,000 with a portion of the proceeds.

Edgar Filing: CREDO PETROLEUM CORP - Form 10-Q

The average return on the company's investments for the nine months ended July 31, 2008 and 2007 was (3.0%) and 9.2%, respectively. At July 31, 2008, approximately 92% of the investments are in managed partnerships (generally known as hedge funds) that use various strategies to minimize their correlation to stock market movements. The remaining investments were directly invested in mutual funds. Most of the investments are highly liquid and the company believes they represent a responsible approach to cash management. In the company's opinion, the greatest investment risk is the potential for negative market impact from unexpected, major adverse news.

Existing working capital and anticipated cash flow are expected to be sufficient to fund operations and capital commitments for at least the next 12 months. At July 31, 2008, the company had no lines of credit or other bank financing arrangements except for the hedging line of credit discussed in Note 4. Because earnings are anticipated to be reinvested in operations, cash dividends are not expected to be paid. The company has no defined benefit plans and no obligations for post retirement employee benefits.

The company's adjusted earnings before unrealized gains/losses on derivative contracts, interest, taxes, depreciation, depletion and amortization, (EBITDA) increased to \$9,505,000 for the nine months ended July 31, 2008 from \$9,427,000 for the nine months ended July 31, 2007. EBITDA is not a GAAP measure of operating performance. The company uses this non-GAAP performance measure primarily to compare its performance with other companies in the industry that make a similar disclosure. The company believes that this performance measure may also be useful to investors for the same purpose. Investors should not consider this measure in isolation or as a substitute for operating income, or any other measure for determining the company's operating performance that is calculated in accordance with GAAP. In addition, because EBITDA is not a GAAP

Table of Contents

measure, it may not necessarily be comparable to similarly titled measures employed by other companies. A reconciliation between EBITDA and net income is provided in the table below:

| | Nine Months Ended July 31, | |
|--|----------------------------|--------------------|
| | 2008 | 2007 (Restated) |
| RECONCILIATION OF EBITDA: | | |
| Net Income | \$ 4,036,000 | \$ 5,038,000 |
| Add Back: | | |
| Unrealized Gain (Loss) on Derivatives | 1,309,000 | (423,000) |
| Interest Expense | 7,000 | 20,000 |
| Income Tax Expense | 1,559,000 | 2,010,000 |
| Depreciation, Depletion and Amortization Expense | 2,594,000 | 2,782,000 |
| EBITDA | \$ 9,505,000 | \$ 9,427,000 |

OFF-BALANCE SHEET FINANCING

The company has no significant off-balance sheet financing arrangements at July 31, 2008.

PRODUCT PRICES AND PRODUCTION

Although product prices are key to the company's ability to operate profitably and to budget capital expenditures, they are beyond the company's control and are difficult to predict. Since 1991, the company has periodically hedged the price of a portion of its estimated natural gas production when the potential for significant downward price movement is anticipated. Hedging transactions typically take the form of forward short positions, swaps and collars which are executed on the NYMEX futures market or by indexing to regional index prices associated with pipelines in proximity to the company's production. The company's current hedges are indexed to NYMEX. Refer to Note 4 of the Consolidated Financial Statements for a complete discussion on the company's hedging activities.

Gas and oil sales volume and price realization comparisons for the indicated periods are set forth below. Price realizations include the sales price and the effect of realized hedging transactions.

| Product | 2008 | | Nine Months Ended July 31, | | 2007 | | % Change | |
|------------|-----------|------------|----------------------------|------------|--------|-------|----------|-------|
| | Volume | Price | Volume | Price | Volume | Price | Volume | Price |
| Gas (Mcf) | 1,221,000 | \$ 7.87(1) | 1,517,000 | \$ 6.72(2) | | | -19% | +17% |
| Oil (bbls) | 42,500 | \$ 101.66 | 37,200 | \$ 56.52 | | | +14% | +80% |

| | 2008 | Three Months Ended July 31, | | 2007 | % Change |
|--|------|-----------------------------|--|------|----------|
|--|------|-----------------------------|--|------|----------|

Edgar Filing: CREDO PETROLEUM CORP - Form 10-Q

| Product | Volume | Price | Volume | Price | Volume | Price |
|------------|----------------|-------------------|---------|------------|--------|-------|
| Gas (Mcf) | 396,000 | \$ 6.96(3) | 494,000 | \$ 6.21(4) | -20% | +12% |
| Oil (bbls) | 13,400 | \$ 122.91 | 12,100 | \$ 62.36 | +11% | +97% |

(1) Includes \$0.32 per Mcf realized hedging loss.

(2) Includes \$0.77 per Mcf realized hedging gain.

(3) Includes \$3.13 per Mcf realized hedging loss.

(4) Includes \$0.41 per Mcf realized hedging gain.

Table of Contents

OPERATIONS

During the first three quarters of fiscal 2008, the company's operations continued to focus on its two core projects – natural gas drilling and application of its patented Calliope Gas Recovery System.

The company believes that, in combination, its drilling and Calliope projects provide an excellent (and possibly unique) balance for achieving its goal of adding long-lived natural gas reserves and production at reasonable costs and risks. However, it should be expected that successful results will occur unevenly for both the drilling and Calliope projects. Drilling results are dependent on both the timing of drilling and on the drilling success rate. Calliope results are primarily dependent on the timing, volume and quality of Calliope installations available to the company.

The company will continue to actively pursue adding reserves through its two core projects in fiscal 2008, and expects these activities to be a reliable source of reserve additions. However, the timing and extent of such activities can be dependent on many factors which are beyond the company's control, including but not limited to, the availability, cost and quality of oil field services such as drilling rigs, production equipment and related services, and access to wells for application of the company's patented gas recovery system on low pressure gas wells. The prevailing price of oil and natural gas has a significant effect on demand and, thus, the related cost of such services and wells.

The cost of field services, particularly the cost of drilling wells, has increased dramatically during the past several years, driven by higher energy prices. Concurrently, the quality of field services has diminished markedly due to manpower shortages. The combination of much higher field service costs and degradation in the quality of the services is having a materially negative impact on drilling economics. Accordingly, the company continues to high-grade its drilling prospects, and in some cases postpone less robust projects pending improvement in the field services sector. In the short term, this will reduce the number of drilling prospects which may, in turn, impede the growth of the company's production and reserves.

The company is currently experiencing delays in securing drilling rigs and delivery of production equipment, primarily compressors and coil tubing. These delays are extending the time it takes the company to conduct its field operations. As a result, the company could be at risk for price increases related to these types of services and equipment.

All of the company's oil and natural gas properties are located on-shore in the continental United States. The company's future drilling activities may not be successful, and its overall drilling success rate may change. Unsuccessful drilling activities could have a material adverse effect on the company's results of operations and financial condition. Also, the company may not be able to obtain the right to drill in areas where it believes there is significant potential for the company.

Drilling Activities.

Oklahoma and Texas Panhandle The company owns a significant inventory of acreage (approximately 70,000 gross acres)

located along the northern portion of the Anadarko Basin where it conducts an active drilling program. Wells generally target the Morrow, Oswego and Chester formations between 7,000 and 11,000 feet. The company expects to drill a substantial number of additional wells on this acreage.

In Hemphill County, Texas, the second well on the company's 3,780 gross acre Humphreys Prospect encountered sands in the Tonkawa and Cleveland formations that appear to be productive on electric logs. The vertical well has been completed in the Tonkawa sand and tested at good rates for both oil and gas. The well is currently waiting on pipeline connection. The company owns a 25% working interest.

Table of Contents

The company recently purchased interests in over 3,800 gross acres in Hemphill County and has taken over as operator of 11 wells. The new acreage complements the company's Humphreys Prospect and brings its total acreage in the area to approximately 8,300 gross acres.

In Oklahoma, three new wells are awaiting pipeline connection and six wells are scheduled for drilling. CREDO owns approximately 70,000 gross acres located primarily along the northern portion of the Anadarko Basin where it conducts an active drilling program. Wells generally target the Morrow, Oswego and Chester formations between 7,000 and 11,000 feet.

In Carter County, CREDO is waiting on rig arrival to drill a twin well to its Schaff #1 which has produced 235,000 barrels of oil. The Schaff well will become part of the Twin Forks Deese sand waterflood, and the new well will develop three oil sands that the Schaff well logs indicate are productive and which produce in the immediate area. CREDO owns a 41% working interest and is the operator.

In Major County, drilling is expected to commence shortly on the company's 1,280 gross acre Pool-Proffitt property. The 9,600-foot Lemmons #1-7 and Ball #1-18 wells will test a thick package of stacked carbonate zones. CREDO owns an approximate 70% working interest in the Lemmons and 50% of the Ball. Ultimately, the company expects to drill 10 to 12 wells on the prospect.

In Harper County, drilling will commence shortly on two wells located on the company's 3,840 gross acre Buffalo Creek Prospect where 11 wells have previously been completed for production. Both of the new wells will test the Chester formation at approximately 6,900 feet. CREDO owns working interests of 30% and 37% in the two wells.

In Southern Oklahoma, the company is participating in three waterflood projects as part of its overall strategy to improve the oil ratio in its reserve base. In Carter County, CREDO owns 17% of the Southeast Hewitt waterflood unit which has already produced 685,000 barrels of oil and is projected to ultimately produce about 1,200,000 barrels. The company also owns about 22% in Phase 1, and 12.3% in Phase 2, of a Twin Forks Deese sand waterflood unit that is being formed and is expected to produce about 1,000,000 barrels of oil. In Love County, CREDO owns 13% in Phase 1, and 9.5% in Phase 2, of the Eastman Hills waterflood unit that is expected to produce about 500,000 barrels of oil.

South Texas In South Texas, the initial test well on the Gemini Prospect resulted in a dry hole. The 17,000-foot well confirmed the seismic interpretation and found porous sand. However, the sand was water wet and the well was plugged and abandoned. CREDO received approximately \$1,300,000 of cash for the multiple prospect package and retained an 11.25% carried interest in the test well.

The prospect package consists of two additional Deep Wilcox prospects located to the north of Gemini Prospect. These two prospects are structurally different and unique compared to the Gemini Prospect. Those prospects are being further evaluated, and if drilled, CREDO will have the same 11.25% carried interest in the next well as it did in the Gemini Prospect test well.

Edgar Filing: CREDO PETROLEUM CORP - Form 10-Q

Elsewhere in South Texas, the company has recently purchased a 15.5% working interest in the Escobas Field. A major workover is underway on an existing well, and a new 15,500-foot Wilcox well has been drilled in which the company has a small carried interest. That well is currently producing 2.7 MMcfd (million cubic of gas per day) on a 12/64ths choke.

North-Central Kansas The company's Kansas acreage is located in prolific oil producing areas where 3-D seismic has proven effective in identifying undrilled structures. Drilling targets the Lansing-Kansas City and Arbuckle formations at about 4,000 feet, making the cost of drilling very inexpensive in relation to potential reserve value.

To date, 26 wells have been drilled on company acreage, of which 46% have been successful. Five of the

Table of Contents

12 successful wells had initial production rates of about 100 barrels of oil per day. Average proved reserves are estimated to be 50,000 to 55,000 barrels of oil per well. The company's first discovery in the play has already produced about 56,000 barrels of oil in 21 months and is still producing 75 barrels of oil per day. That well is expected to produce around 130,000 barrels of oil.

Since the company's last report, six wells have been drilled of which four are producers, yielding a 67% success rate. Six new wells are scheduled for the next few months, half of which will be on prospects where the company owns an 80% working interest.

Credo has acquired approximately 100,000 gross acres (35,000 net acres) located in prolific oil producing areas of the play and is continuing to expand its acreage position. The company currently owns interests ranging from 12.5% to 80% in 16 separate projects. Three dimensional (3-D) seismic has proven effective in identifying undrilled structures. Drilling targets the Lansing-Kansas City and Arbuckle formations at about 4,000 feet, making the cost of drilling moderate in relation to potential reserve value. Recent drilling successes have occurred primarily on prospects where the company owns smaller working interests.

Drilling success in this play is progressing well. In addition to providing good diversification to our other drilling activities, this project is 100% oil oriented and is expected to improve the balance between oil and natural gas in the company's reserve base.

Calliope Gas Recovery Technology.

The company owns the exclusive right to a patented technology known as the Calliope Gas Recovery System. There are currently three U.S. patents and two Canadian patents related to the technology. One additional patent that mirrors the U.S. patents has been applied for in Canada. Calliope systems are installed on wells located in Oklahoma, Texas and Louisiana.

Calliope can achieve substantially lower flowing bottom-hole pressure than other production methods because it does not rely on reservoir pressure to lift liquids. In many reservoirs, lower bottom-hole pressure can translate into recovery of substantial additional natural gas reserves.

Calliope has proven to be reliable and flexible over a wide range of applications on wells the company owns and operates. It has also proven to be consistently successful. Accordingly, the company is implementing strategies designed to expand the population of wells on which it can install Calliope.

Calliope's Track Record Calliope wells are located in Oklahoma, Texas, and Louisiana and produce from both sandstone and carbonate reservoirs, including the Chester, Cotton Valley, Edwards, Hart, Hunton, Morrow, Nodosaria, Redfork and Springer formations. The Calliope wells range in depth from 6,400 to 18,400 feet. These wells represent rigorous applications for Calliope because at the time Calliope was installed, 14 of the wells were dead (an average of two to

three years), nine were uneconomic and two were marginal. In addition, prior to the time Calliope was installed, many of the reservoirs were damaged by the parting shots of previous operators. Twenty-three of the wells were acquired from other operators after the operators had given-up on these wells. The previous operators were mostly medium to large independent oil and gas companies.

Initial Calliope production rates range up to 650 Mcfd and average per well Calliope reserves for non-experimental wells are estimated to be 1.0 Bcf. One of the company's early Calliope installations, the J.C. Carroll well, has now produced over a billion cubic feet of gas using Calliope.

The 25 Calliope installed applications are grouped into two categories - experimental wells and non-experimental wells, also referred to as go-forward applications. Eleven of the 25 wells are experimental applications and 14 are go-forward applications. Experimental wells generally represent the

Table of Contents

first experimental application of a Calliope configuration in a wellbore. For example, the first installation of Calliope inside a particular tubing size is classified as an experimental application.

Calliope has achieved compelling results on these less than ideal wells as is shown in the table below. For example, the entire group of 14 non-experimental wells were producing a total of only 88 Mcfd when Calliope was installed. Without Calliope, the wells represented a substantial plugging liability. However, with Calliope, those same 14 wells have now produced an incremental 3.4 Bcfe to date, and they are still producing about 2.0 MMcfed. With Calliope, the 14 wells were projected to have estimated ultimate incremental Calliope reserves totaling 13.6 Bcfe.

| Group | No. of Wells | Average Calliope Reserves Per Well (Bcfe) | Total Calliope Production to Date (Bcfe) | Total Projected Calliope Reserves (Bcfe) |
|-------------------------------|--------------|---|--|--|
| Non-Experimental Wells | 14 | 1.0 | 3.4 | 13.6 |
| Experimental Wells | 11 | 0.2 | 0.6 | 1.4 |
| All Wells | 25 | 0.6 | 4.0 | 15.0 |

Calliope has proven to be a low risk and low cost liquid lift technology. Calliope has never failed to lift the liquids out of a wellbore. The average cost of a Calliope system is \$400,000 for a 12,000-foot application. Based on average per well Calliope reserves of 1.0 Bcfe for go-forward applications, cost of Calliope in terms of units of natural gas reserves added is low compared to industry averages. Based on current natural gas prices, Calliope can economically be installed on wells which will yield significantly less than 1.0 Bcf of Calliope reserves. This will enable the company to significantly expand the range of Calliope applications to include many low permeability reservoirs, possibly including those in shale and other resource plays.

Realizing Calliope's value continues to be one of the company's top priorities. The company has been focused on three fronts to increase the number of Calliope installations: expanding the geographic region for purchasing Calliope candidate wells from third parties, joint ventures with larger companies, and drilling wells into low-pressure gas reservoirs for the purpose of using Calliope to recover stranded natural gas reserves.

Purchasing Calliope Candidate Wells Calliope operations were expanded into Texas and Louisiana in fiscal 2006. The company considers Texas and Louisiana to be very fertile areas for Calliope and has retained personnel and opened a Houston office to focus exclusively on purchasing wells for Calliope and on Calliope joint ventures.

In general, higher natural gas prices have made it increasingly difficult for the company to purchase wells for its Calliope system. In addition, higher gas prices have provided the incentive for other companies to perform high risk procedures (parting shots) in an attempt to revive wells prior to abandoning or selling the wells. These parting shots often result in severe reservoir damage that renders wells unsuitable for Calliope. Accordingly, viable Calliope candidate wells available to be purchased by the company have been very restricted.

Joint Ventures With Third Parties In an effort to increase the number of Calliope installations, the company has been discussing joint ventures with larger companies. Presentations have been made to a select group of companies, including majors and large independents. All of the companies have expressed an interest in Calliope. Two joint venture agreements were completed during 2007.

Table of Contents

Joint venture discussions are in progress with a number of the companies, including evaluation of candidate wells. The joint venture negotiation process has taken longer than expected because there are many decision points within large companies that cause delays. Nevertheless, the company continues to dedicate substantial resources to joint venture projects because it believes joint venturing holds substantial promise for Calliope.

Calliope Drilling Project The company believes that there is a huge amount of gas stranded in abandoned and low pressure reservoirs that can be recovered using Calliope. It believes drilling new wells for Calliope into such reservoirs will provide a repeatable opportunity to lease large areas for systematic re-development. In addition, new wells allow optimum casing and tubular sizes to be installed which will substantially improve reserves and production compared to installing Calliope on existing wells where undersized tubulars often restrict Calliope's optimum performance.

In June 2007, the company entered into a joint venture to purchase an 11,000-foot well located in East Texas. The previous operator drilled the well and encountered low reservoir pressure. After unsuccessful attempts to make the well produce, the operator sold the well to the company joint venture for \$65,000 (salvage value). Calliope was installed and immediately brought the well to life, producing at the rate of 250 Mcf per day. The well provided a successful test of the Calliope drilling concept and demonstrated that Calliope will successfully solve liquid loading problems that are difficult, if not impossible, to address with other liquid lift technologies.

Results of Operations

Nine Months Ended July 31, 2008 Compared to Nine Months Ended July 31, 2007

For the nine months ended July 31, 2008, total revenues increased 22% to \$14,446,000 compared to \$11,806,000 last year. As the oil and gas price/volume table on page 16 shows, total gas price realizations, which reflect realized hedging transactions, increased 17% to \$7.87 per Mcf and oil price realizations increased 80% to \$101.66 per barrel. The net effect of these price changes was to increase oil and gas sales by \$3,509,000 (\$5,069,000 before realized hedge losses). For the nine months ended July 31, 2008, the company's gas equivalent production decreased 15%. The effect of the volume change was to decrease oil and gas sales by \$1,881,000. The production decrease is primarily due to the continued steep decline of the Glacier property wells. Investment income and other decreased \$560,000 primarily due to performance of the company's investments.

For the nine months ended July 31, 2008, total costs and expenses rose 2% to \$6,518,000 compared to \$6,368,000 for the comparable period in 2007. Oil and gas production expenses increased 13% due to the addition of new wells and escalating field service costs. Depreciation, depletion and amortization (DD&A) decreased primarily due to decreased production partially offset by an increase in the amortizable cost base. General and administrative expenses increased 1% primarily due to accounting and professional fees. Interest expense relates to the exclusive license agreement note payment. The effective tax rate was 28.0% for 2008 and 28.5% for 2007.

Table of Contents

Three Months Ended July 31, 2008 Compared to Three Months Ended July 31, 2007

For the three months ended July 31, 2008, total revenues increased 48% to \$5,695,000 compared to \$3,846,000 during the same period last year. As the oil and gas price/volume table on page 16 shows, total gas price realizations, which reflect realized hedging transactions, increased 12% to \$6.96 per Mcf and oil price realizations increased 97% to \$122.91 per barrel. The net effect of these price changes was to increase oil and gas sales by \$1,400,000 (\$2,840,000 before realized hedge losses). For the three months ended July 31, 2008, the company's gas equivalent production fell 16% resulting in an oil and gas sales decrease of \$807,000. Investment and other income decreased \$184,000 primarily due to performance of the company's investments, compared to last year.

For the three months ended July 31, 2008, total costs and expenses increased 6% to \$2,227,000 compared to \$2,102,000 for the comparable period in 2007. Oil and gas production expenses increased 25% primarily due to the addition of new wells and escalating field service costs. DD&A declined primarily due to lower production partially offset by an increase in the amortizable cost base. General and administrative expenses decreased primarily due to an increase in geology and engineering costs capitalized to drilling projects. Interest expense relates to the exclusive license agreement note payment. The effective tax rate was 27.4% for 2008 and 28.3% for 2007.

SIGNIFICANT ACCOUNTING POLICIES

The company believes the following accounting policies and estimates are critical in the preparation of its consolidated financial statements: the carrying value of its oil and natural gas properties, the accounting for oil and gas reserves, and the estimate of its asset retirement obligations.

OIL AND GAS PROPERTIES. The company uses the full cost method of accounting for costs related to its oil and natural gas properties. Capitalized costs included in the full cost pool are depleted on an aggregate basis using the units-of-production method. Depreciation, depletion and amortization is a significant component of oil and natural gas properties. A change in proved reserves without a corresponding change in capitalized costs will cause the depletion rate to increase or decrease.

Both the volume of proved reserves and any estimated future expenditures used for the depletion calculation are based on estimates such as those described under "Oil and Gas Reserves" below.

The capitalized costs in the full cost pool are subject to a quarterly ceiling test that limits such pooled costs to the aggregate of the present value of future net revenues attributable to proved oil and natural gas reserves discounted at 10 percent plus the lower of cost or market value of unproved properties less any associated tax effects. If such capitalized costs exceed the ceiling, the company will record a write-down to the extent of such excess as a non-cash charge to earnings. Any such write-down will reduce earnings in the period of occurrence and result in lower depreciation and depletion in future periods. A write-down may not be reversed in future periods, even though higher oil and natural gas prices may subsequently increase the ceiling.

Edgar Filing: CREDO PETROLEUM CORP - Form 10-Q

The company has made only one ceiling write-down in its 28-year history. That write down was made in 1986 after oil prices fell 51% and natural gas prices fell 45% between fiscal year end 1985 and 1986.

Changes in oil and natural gas prices have historically had the most significant impact on the company's ceiling test. In general, the ceiling is lower when prices are lower. Even though oil and natural gas prices can be highly volatile over weeks and even days, the ceiling calculation dictates that prices in effect as of the last day of the test period be used and held constant. The resulting valuation is a snapshot as of that day and, thus, is generally not indicative of a true fair value that would be placed on the company's reserves by the company or by an independent third party. Therefore, the future net revenues associated

Table of Contents

with the estimated proved reserves are not based on the company's assessment of future prices or costs, but rather are based on prices and costs in effect as of the end the test period.

OIL AND GAS RESERVES. The determination of depreciation and depletion expense as well as ceiling test write-downs related to the recorded value of the company's oil and natural gas properties are highly dependent on the estimates of the proved oil and natural gas reserves. Oil and natural gas reserves include proved reserves that represent estimated quantities of crude oil and natural gas which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions. There are numerous uncertainties inherent in estimating oil and natural gas reserves and their values, including many factors beyond the company's control. Accordingly, reserve estimates are often different from the quantities of oil and natural gas ultimately recovered and the corresponding lifting costs associated with the recovery of these reserves.

ASSET RETIREMENT OBLIGATIONS. The company estimates the future cost of asset retirement obligations, discounts that cost to its present value, and records a corresponding asset and liability in its Consolidated Balance Sheets. The values ultimately derived are based on many significant estimates, including future abandonment costs, inflation, market risk premiums, useful life, and cost of capital. The nature of these estimates requires the company to make judgments based on historical experience and future expectations. Revisions to the estimates may be required based on such things as changes to cost estimates or the timing of future cash outlays. Any such changes that result in upward or downward revisions in the estimated obligation will result in an adjustment to the related capitalized asset and corresponding liability on a prospective basis.

REVENUE RECOGNITION. The company derives its revenue primarily from the sale of produced natural gas and crude oil. The company reports revenue gross for the amounts received before taking into account production taxes and transportation costs which are reported as oil and gas production expenses. Revenue is recorded in the month production is delivered to the purchaser at which time title changes hands. The company makes estimates of the amount of production delivered to purchasers and the prices it will receive. The company uses its knowledge of its properties, their historical performance, the anticipated effect of weather conditions during the month of production, NYMEX and local spot market prices, and other factors as the basis for these estimates. Variances between estimates and the actual amounts received are recorded when payment is received.

A majority of the company's sales are made under contractual arrangements with terms that are considered to be usual and customary in the oil and gas industry. The contracts are for periods of up to five years with prices determined based upon a percentage of a pre-determined and published monthly index price. The terms of these contracts have not had an effect on how the company recognizes its revenue.

HEDGING. The company recognizes all derivatives as fair value hedges on its balance sheet at fair value at the end of each period. Changes in the fair value of hedges are now recorded in the Consolidated Statement of Operations

ITEM 3.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The company manages exposure to commodity price fluctuations by periodically hedging a portion of expected production through the use of derivatives, typically collars and forward short positions in the NYMEX or other regional indexes futures market. See Note 4 for more information on the company's hedging activities.

Table of Contents

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management evaluated, with the participation and under the supervision of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure and that such information is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting that occurred during our last fiscal quarter that has materially affected or is reasonably likely to materially affect our internal control over financial reporting, except as follows: In Item 9A, "Management's Report on Internal Control over Financial Reporting" included in our Annual Report on Form 10-K/A for the year ended October 31, 2007 we reported a material weakness in the company's internal control. During the first and second quarters of fiscal 2008: 1) management designed and implemented enhanced and accelerated training for its senior financial staff and invested time and resources to enhance their knowledge and skills; and 2) the company hired an expert consultant to assist with review and financial statement disclosure. Management has not completed all of the testing of internal controls in these areas for fiscal 2008.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Reference is made to "Notes to Consolidated Financial Statements (Unaudited) - Note 7, Commitments and Contingencies", in Part I, Item I of this Form 10-Q and incorporated by reference in this Part II, Item I.

ITEM 1A. RISK FACTORS

There have been no material changes from the risk factors previously disclosed in the company's Annual Report on Form 10-K/A for the fiscal year ended October 31, 2007.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On July 3, 2008 the company completed the sale of 1,150,000 shares of its \$0.10 par value common stock. The sales price was \$14.50 per share resulting in total proceeds of \$16,675,000.

Proceeds were used to pay transaction fees of \$1,564,000 and purchase joint venture holders' rights to future Calliope installation revenues of \$975,000.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

Table of Contents

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibits are as follow:

31.1 Certification by Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification by Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification by Chief Executive Officer and Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act (18 U.S.C. Section 1350)

Table of Contents

SIGNATURES

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

CREDO Petroleum Corporation
(Registrant)

By: /s/ James T. Huffman
James T. Huffman
President and Chief Executive Officer
(Principal Executive Officer)

By: /s/ Alford B. Neely
Alford B. Neely
Vice President & Chief Financial Officer
(Principal Financial and Accounting Officer)

Date: September 15, 2008