

CARBON ENERGY CORP
Form 10-K/A
September 15, 2003

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SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 10-K/A

Amendment No. 2

Annual Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934

For the Fiscal Year Ended December 31, 2002

Commission File Number 1-15639

CARBON ENERGY CORPORATION

(Exact name of Registrant as specified in its Charter)

Colorado
(State of Incorporation)

84-1515097
(I.R.S. Employer Identification No.)

1700 Broadway, Suite 1150
Denver, Colorado
(Address of principal executive offices)

80290
(Zip Code)

Registrants telephone number, including area code: **(303) 863-1555**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of Exchange on which registered
Common Stock, (no par value)	American Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: **None**

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

The aggregate market value of the 1,107,714 shares of voting stock held by non-affiliates of the registrant, based upon the closing sale price of the common stock on June 30, 2002 of \$9.69 per share as reported on the American Stock Exchange, was \$10,733,749. Shares of common stock held by each officer and director and by each person who owns 5% or more of the outstanding common stock have been excluded in that such persons may be deemed affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

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As of March 19, 2003, the registrant had 6,150,323 shares of common stock outstanding.

PART I

ITEM 1. BUSINESS

GENERAL

Carbon Energy Corporation (the Company or Carbon) was incorporated on September 14, 1999 under the Colorado Business Corporation Act. The Company's business is comprised of the assets and properties of Carbon Energy Corporation (USA) (Carbon USA), which conducts the Company's operations in the United States and the assets and properties of Carbon Energy Canada Corporation (Carbon Canada), which conducts the Company's operations in Canada. Effective July 11, 2002, Carbon changed the name of its United States subsidiary from Bonneville Fuels Corporation (Bonneville Fuels) to Carbon Energy Corporation (USA). Effective March 1, 2003, Carbon changed the name of its Canadian subsidiary from CEC Resources Ltd. (CEC Resources) to Carbon Energy Canada Corporation. As the parent company, Carbon provides management services to Carbon USA and Carbon Canada.

Carbon is an independent oil and gas company engaged in the exploration, development and production of natural gas and crude oil in the United States and Canada. The Company's areas of operations in the United States are the Piceance Basin in Colorado, the Uintah Basin in Utah, the Permian Basin in New Mexico and Texas, and Montana. The Company's areas of operations in Canada are central Alberta and southeast Saskatchewan.

All amounts are presented in U.S. dollars unless otherwise noted.

At December 31, 2002, the Company had 67.4 billion cubic feet of natural gas equivalent ("Bcfe" where one barrel of oil is equivalent to six thousand cubic feet of gas) proved reserves compared to 59.0 Bcfe at December 31, 2001. Proved reserves at December 31, 2002 increased by 8.4 Bcfe or 14% compared to December 31, 2001. Net proved natural gas reserves totaled 62.5 Bcf of gas at December 31, 2002 compared to 53.9 Bcf at year end 2001, an increase of 8.6 Bcf or 16%. Crude oil and natural gas liquids at December 31, 2002 totaled 822,000 barrels compared to 851,000 barrels at year end 2001, a decrease of 29,000 barrels or 3%. Of these proved reserves, approximately 93% on a Mcfe basis are gas and approximately 74% are categorized as proved developed. At December 31, 2002, the pretax net present value of the reserves using year end prices and costs held constant and discounted at 10% was \$106 million.

At December 31, 2002, Carbon USA's exploration and production operations were comprised of working interests in 246 producing oil and gas wells. Carbon USA operates 151 of these wells. At December 31, 2002, Carbon USA had an interest in over 179,000 net acres of oil and gas leases primarily located in the Piceance Basin of Colorado, the Uintah Basin of Utah, the Permian Basin of New Mexico and Texas, and Montana. During 2002, Carbon USA produced 3.0 Bcf of gas and 91,300 barrels of oil and natural gas liquids, amounting to 3.6 Bcfe or an average of 9.9 MMcfe per day. The addition during 2002 of 7.0 Bcfe to Carbon USA's net proved reserves resulted in a reserve replacement of 194% of the Company's 2002 production in the United States.

In September 2002, Carbon USA sold its interest in 20 producing natural gas and oil wells located primarily in Stanton and Morton counties, Kansas for \$2.1 million in cash. On March 24, 2003, Carbon USA closed the sale of its interest in 97 gross (23.3 net) wells and 26,300 gross (8,000 net) acres located primarily in southeast New Mexico. The sale price was \$15.7 million in cash, with an effective date of January 1, 2003. Daily average net production from the New Mexico properties was approximately 3,300 Mcf of gas per day and 130 barrels of oil per day. These asset sales completed Carbon's program to sell assets acquired in the 1999 purchase of Bonneville Fuels that did not fit with the Company's focus on the development of its natural gas properties in the Piceance and Uintah Basins and in central Alberta.

At December 31, 2002, the estimated proved reserves attributed to the properties divested in March 2003 were 172,000 barrels and 7.3 Bcf of gas. The pretax net present value of these reserves using year end 2002 prices (except to the extent provided by contractual arrangement in existence at year end) and costs held constant and discounted at 10% was \$15.9 million.

At December 31, 2002, Carbon Canada's exploration and production operations were comprised of working interests in 94 producing oil and natural gas wells located in Alberta and Saskatchewan. Carbon Canada operates 51 of these wells. The Company had an interest in over 49,000 net acres of oil and gas leases. During 2002, Carbon Canada produced 2.2 Bcf of gas and 50,300 barrels of oil and natural gas liquids, amounting to 2.5 Bcfe or an average of 6.9 MMcfe per day. The addition of 9.2 Bcfe to Carbon's net proved reserves resulted in a reserve replacement of 368% of the Company's 2002 production in Canada.

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For information regarding Carbon's geographic segments, see Note 7 to the Consolidated Financial Statements.

On August 11, 1999, Carbon Canada entered into a stock purchase agreement with Bonneville Pacific Corporation (BPC), parent company of Carbon USA, for the purchase of all outstanding shares of Carbon USA. Rights and obligations of Carbon Canada under the stock purchase agreement were assigned to Carbon. Yorktown Energy Partners III, LP (Yorktown) purchased 4,500,000 shares of Carbon for \$24.8 million. The funds from this purchase were used to acquire, on October 29, 1999, the Carbon USA shares under the stock purchase agreement and to pay expenses incurred in connection with the purchase and related transactions. The total cash purchase price after adjustments for Carbon USA was \$23.5 million.

On January 21, 2000, Carbon commenced an exchange offer for shares of Carbon Canada. Through the exchange offer, Carbon offered to exchange one share of Carbon stock for each share of Carbon Canada stock. On February 18, 2000, the Company completed its offer to exchange Carbon shares for shares of Carbon Canada. Of the 1.5 million outstanding shares of Carbon Canada, over 97% of the shares were exchanged. Carbon began trading its shares on the American Stock Exchange on February 24, 2000 under the trading symbol CRB. On February 28, 2000, at the request of Carbon Canada, the Securities and Exchange Commission (SEC) approved the delisting of Carbon Canada's common stock from the American Stock Exchange.

On November 22, 2000, at the direction of its Board of Directors, Carbon Canada initiated an offer to purchase shares (the Offer) of Carbon Canada stock that were not owned by Carbon. The Offer was completed on February 6, 2001. Carbon Canada conducted the Offer in order to avoid the administrative costs and time involved in corresponding with a small number of minority shareholders. The Board of Directors of Carbon Canada maintained a neutral position in regard to the Offer because of potential conflicts of interest. Of the approximate 39,000 shares of Carbon Canada that were not acquired by Carbon in the original exchange offer, approximately 34,000 shares of Carbon Canada stock were purchased by Carbon Canada pursuant to the Offer.

On October 30, 2002, at a special meeting of the holders of Carbon Canada common stock, a special resolution was passed to amend the articles of Carbon Canada to consolidate its issued and outstanding common shares on a one-for-2,500 basis. The Board of Directors of Carbon Canada recommended the consolidation in order to avoid the administrative costs and time involved in corresponding with a small number of minority shareholders. On November 15, 2002, Carbon Canada initiated the exchange of common shares for post-consolidation shares or a cash payment in lieu of fractional post-consolidation shares. The exchange was completed on January 13, 2003. After the completion of the exchange, Carbon owns 100% of the stock of Carbon Canada.

On March 31, 2003, Carbon announced that it had entered into an Agreement and Plan of Reorganization (the Merger Agreement) with Evergreen Resources (Evergreen). Under the Merger Agreement, Carbon will merge with a subsidiary of Evergreen, and Carbon shareholders will receive .275 shares of Evergreen common stock for each outstanding share of Carbon common stock (and cash in lieu of any fractional shares). As a result of the merger, Carbon will become a wholly owned subsidiary of Evergreen. The merger is intended to be a tax-free, stock-for-stock transaction.

The Board of Directors of Carbon and Evergreen each unanimously approved the Merger Agreement. At the time of execution of the agreement, each of Yorktown and Patrick R. McDonald, President and Chief Executive Officer of Carbon, who beneficially own approximately 73.2% and 6.0%, respectively, of Carbon's outstanding common stock, has executed an agreement with Evergreen obligating each of them to vote all shares over which it has voting control in favor of the merger.

RBC Capital Markets acted as the financial advisor to Carbon and rendered a fairness opinion to the Board of Directors of Carbon.

Completion of the merger, which is subject to customary conditions, including approval by the shareholders of Carbon, is expected to occur late in the second quarter or in the third quarter of 2003. The Merger Agreement contains a \$2.5 million termination fee payable by Carbon if the Merger Agreement is terminated under certain circumstances.

BUSINESS STRATEGY

The Company's objective is to build shareholder value through consistent growth in reserves and production and to increase net asset value, cash flow, and earnings per share. Our business strategy is to grow through the exploration and development of oil and gas properties, by the acquisition of complementary properties and through the optimization of gathering, compression and processing facilities. In addition we seek opportunities to acquire additional oil and gas mineral leases and create drilling opportunities based on internally generated geological and engineering concepts. Management believes that the Company's existing infrastructure and its acreage position in the Piceance Basin in Colorado and the Uintah Basin in Utah and the Carbon and Rowley areas of Alberta, Canada provide the Company with an excellent opportunity to achieve its objectives. The Company may also pursue property acquisition opportunities in its areas of operations. The Company's objective and business strategy is subject to the proposed merger described above.

EMPLOYEES AND OFFICES

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As of December 31, 2002, the Company had 24 employees located in Denver, Colorado and 12 in Calgary, Alberta. None of these employees are represented by a labor union. The Company's executive offices are located at 1700 Broadway, Suite 1150, Denver, Colorado 80290, and its telephone number is (303) 863-1555.

ITEM 2. PROPERTIES

United States

Piceance and Uintah Basins At December 31, 2002, Carbon owned working interests in 148 gross (128.7 net) producing wells in the Piceance Basin of Colorado and Uintah Basin of Utah. Carbon operates 132 of these wells. For the year ended December 31, 2002, the Company participated in the drilling of three gross (2.7 net) wells, all of which were completed as natural gas wells. The Company has leasehold rights in approximately 147,000 gross (126,000 net) acres of which approximately 108,000 gross (93,000 net) acres are undeveloped. Approximately 77,000 gross (62,000 net) undeveloped acres are held by production. Subject to completion of the proposed merger described previously, Carbon USA's focus in the United States during 2003 is to continue the development of its natural gas properties in the Rocky Mountains, with emphasis on the Piceance and Uintah Basins.

Permian Basin At December 31, 2002, Carbon owned working interests in 97 gross (23.3 net) producing wells in the Permian Basin of New Mexico and Texas. Carbon operates 18 of these wells. For the year ended December 31, 2002, the Company participated in the drilling of six gross (.7 net) wells, of which one gross (.1 net) was completed as a natural gas well, four gross (.3 net) were completed as oil wells and one gross (.3 net) was abandoned as a dry hole. The Company has leasehold rights in approximately 25,000 gross (8,000 net) acres of which approximately 8,000 gross (4,000 net) acres are undeveloped. Approximately 8,000 gross (2,000 net) undeveloped acres are held by production. In March 2003, Carbon USA sold its working and related leasehold interests in these properties.

Montana At December 31, 2002, Carbon owned a working interest and operated one gross (1.0 net) producing well in Montana. For the year ended December 31, 2002, the Company participated in the drilling of two gross (2.0 net) wells both of which were abandoned as dry holes. The Company has leasehold rights in approximately 47,000 gross (44,000 net) acres, approximately all of which are undeveloped.

Canada

Alberta At December 31, 2002, Carbon owned working interests in 85 gross (58.4 net) producing wells primarily in the Carbon and Rowley areas of Alberta. Carbon operates 51 of these wells. For the year ended December 31, 2002, the Company participated in the drilling of 17 gross (10.5 net) wells, resulting in 16 gross (10.0 net) natural gas wells and one gross (.5 net) dry hole. The Company has leasehold rights in approximately 76,000 gross (49,000 net) acres of which approximately 27,000 gross (22,000 net) acres are undeveloped. Subject to completion of the proposed merger described previously, Carbon's focus in Canada during 2003 is to continue the development of its natural gas properties in central Alberta, with emphasis on the Carbon and Rowley areas.

Saskatchewan At December 31, 2002, Carbon owned non-operating working interests in nine gross (2.8 net) producing wells in southeast Saskatchewan. For the year ended December 31, 2002, the Company did not participate in any drilling activities in this area. The Company has leasehold rights in approximately 2,000 gross (500 net) acres of which approximately 160 gross (40 net) acres are undeveloped.

RESERVES

The table below sets forth the Company's estimated quantities of historical proved reserves after royalty burdens and the present values attributable to those reserves as of December 31, 2002, 2001 and 2000. The estimates for the Company's reserves in the United States were prepared by Ryder Scott Company, an independent reservoir engineering firm. The estimates for the Company's reserves in Canada were prepared by Sproule Associates Limited, independent geological and petroleum engineering consultants. Additional information regarding the Company's proved and proved developed oil and gas reserves and the standardized measure of discounted net cash flow and changes therein are described in Note 13 to the Consolidated Financial Statements.

	United States			Canada		
	2002	2001	2000	2002	2001	2000
	(dollars in thousands, except price data)					
Estimated proved reserves						
Natural gas (MMcf)	36,677	33,992	32,100	25,805	19,868	18,867

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	United States			Canada		
Oil and liquids (MBbl)	265	412	507	557	439	461
Total MMcfe	38,267	36,464	35,142	29,147	22,502	21,633
Proved developed reserves (MMcfe)(1)	29,991	31,355	28,714	19,959	16,822	18,659
Natural gas price as of December 31 (\$/Mcf)	\$ 3.14	\$ 2.25	\$ 9.76	\$ 3.84	\$ 2.30	\$ 9.00
Oil and liquids price as of December 31 (\$/Bbl)	29.84	18.45	25.50	24.68	13.02	21.73
Present value of estimated future net revenues before future income taxes, discounted at 10%	\$ 42,264	\$ 31,107	\$ 153,528	\$ 63,912	\$ 24,684	\$ 111,461

(1) Proved developed oil and gas reserves are reserves that can be expected to be recovered through existing wells with existing equipment and operating methods.

The estimate of net proved reserves in the United States at December 31, 2000 included volumes attributed to the Company's working interest in 40 natural gas wells located in the San Juan Basin of New Mexico. These properties were sold in January 2001. The estimated proved reserves attributed to these properties were 38,000 barrels of oil and 5.6 Bcf of natural gas. The pretax net present value of these reserves using year end 2000 prices (except to the extent provided by contractual arrangements in existence at year end) and costs held constant and discounted at 10% was \$24.0 million.

The estimate of proved reserves in the United States at December 31, 2002 included volumes attributed to the Company's working interest in 97 gross (23.3 net) wells located primarily in southeast New Mexico. These properties were sold in March 2003. The estimated proved reserves for these properties were 172,000 barrels of oil and 7.3 Bcf of gas. The pretax net present value of these reserves using year end 2002 prices (except to the extent provided by contractual arrangements in existence at year end) and costs held constant and discounted at 10% was \$15.9 million.

Reserve estimates are based upon various assumptions, including assumptions required by the Securities and Exchange Commission relating to oil and gas prices, drilling and operating expenses, capital expenditures, taxes and availability of funds. The process of estimating reserves is complex. This process requires significant decisions and assumptions in the evaluation of available geological, geophysical, engineering and economic data for each reservoir. Therefore, these estimates are not precise.

Actual future production, oil and gas prices, revenues, taxes, development expenditures, operating expenses and quantities of recoverable oil and gas reserves will most likely vary from those estimated. Any significant variance could materially affect the estimated quantities and present value of reserves disclosed by the Company. In addition, the Company may adjust estimates of proved reserves to reflect production history, results of exploration and development, prevailing oil and gas prices and other factors, many of which are beyond its control.

In accordance with applicable requirements of the SEC, estimates of the Company's future net revenues are determined using sale prices estimated to be in effect as of the date of the reserve estimates and are held constant throughout the life of the properties (except to the extent provided by contractual arrangements in existence at year end). Also in accordance with the applicable SEC guidelines, future production costs are held constant at the level observed at the date of the reserve estimates. Declines in the price of oil or gas decrease reserve values by lowering the future net revenues attributable to the reserves and may also reduce the quantities of reserves that are recoverable on an economic basis. Price increases may have the opposite effect. A significant decline in prices of natural gas or oil could have a material adverse effect on the Company's financial condition and results of operations. Prices received for future production and future production costs may vary, perhaps significantly, from the prices and costs assumed for purposes of the estimates.

In general, the volumes of production from Carbon's oil and gas properties decline as reserves of oil and gas are depleted. Except to the extent the Company acquires additional properties containing proved reserves or conducts successful exploration and development activities or both, the proved reserves of the Company will decline as reserves are produced. Reserves generated from future activities of the Company are highly dependent upon the level of success in acquiring or discovering additional reserves and the costs incurred in doing so.

Since January 1, 2002, the Company has filed the Department of Energy Form EIA-23, "Annual Survey of Domestic Oil and Gas Reserves," as required by operators of oil and gas properties in the United States. There are differences between the reserves as reported on Form

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EIA-23 and reserves as reported herein. Form EIA-23 requires that operators report on total proved reserves for operated wells only and that reported reserves be reported on a gross basis rather than on a net basis.

PRODUCTION

The following table sets forth information regarding net oil and natural gas production, average sales prices and other production information. Average sales prices for natural gas, oil and liquids are inclusive of hedging gains and losses for the years ended December 31, 2002, 2001 and 2000:

	United States			Canada(1)		
	2002	2001	2000	2002	2001	2000
Quantities produced and sold						
Natural gas (MMcf)	3,049	2,810	3,374	2,232	2,419	1,312
Oil and liquids (Bbl)	91,297	81,091	69,394	50,274	58,615	39,662
Total MMcfe	3,597	3,297	3,790	2,534	2,771	1,550
Average sales price						
Natural gas (\$/Mcf)	\$ 2.17	\$ 2.94	\$ 2.80	\$ 2.95	\$ 4.05	\$ 3.41
Oil and liquids (\$/Bbl)	21.92	25.49	23.03	19.62	21.76	22.65
Average production (lifting) costs (\$/Mcf)	\$ 0.45	\$ 0.50	\$ 0.42	\$ 0.67	\$ 0.58	\$ 0.51

(1) Canadian results for 2000 are the results of Carbon Canada subsequent to its acquisition by Carbon in February 2000.

PRODUCTIVE WELLS

The following table sets forth information regarding the number of productive wells in which the Company held a working interest at December 31, 2002:

	Productive Wells(1)			
	Gas Wells		Oil Wells	
	Gross(2)	Net(3)	Gross	Net
United States				
Permian Basin	61	13.6	36	9.7
Piceance/Uintah Basins	145	125.7	3	3.0
Montana			1	1.0
Total	206	139.3	40	13.7
Canada				
Alberta	85	58.4		
Saskatchewan			9	2.8
Total	85	58.4	9	2.8
United States and Canada	291	197.7	49	16.5

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Productive Wells(1)

- (1) Each well completed to more than one producing zone is counted as a single well. The Company has royalty interests in certain wells that are not included in this table.
- (2) A gross well is a well in which a working interest is owned. The number of gross wells is the total number of wells in which a working interest is owned.
- (3) A net well is deemed to exist when the sum of fractional ownership working interests in gross wells equals one. The number of net wells is the sum of the fractional working interest owned in gross wells.

The number of productive wells in which the Company held a working interest at December 31, 2002 included 61 gross (13.6 net) gas wells and 36 gross (9.7 net) oil wells attributed to properties located primarily in southeast New Mexico. These properties were sold in March 2003.

DRILLING ACTIVITY

The Company engages in exploratory and developmental drilling on its own and in association with other oil and gas companies. The following table sets forth the wells drilled for the years ended December 31, 2002, 2001 and 2000:

	United States			Canada(1)		
	2002	2001	2000	2002	2001	2000
Gross wells(2)						
Development						
Natural gas	2	6		14	11	8
Oil	4	7	6			
Non-productive(3)				1		
Total	6	13	6	15	11	8
Exploratory						
Natural gas	2	16		2		
Oil		3	4			
Non-productive	3	3	5			
Total	5	22	9	2		
Net wells(4)						
Development						
Natural gas	1.8	4.7		9.0	10.5	4.9
Oil	0.3	2.5	0.4			
Non-productive				0.5		
Total	2.1	7.2	0.4	9.5	10.5	4.9
Exploratory						

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	United States		Canada(1)	
Natural gas	1.0	10.1	1.0	
Oil	2.5	2.5		
Non-productive	2.3	2.5	3.8	
Total	3.3	15.1	6.3	1.0

- (1) The results for 2000 are the results of Carbon Canada subsequent to its acquisition by Carbon in February 2000.
- (2) A gross well is a well in which a working interest is owned. The number of gross wells is the total number of wells in which a working interest is owned.
- (3) A non-productive hole is a well deemed to be incapable of producing either natural gas or oil in sufficient quantities to justify completion as a natural gas or oil well.
- (4) A net well is deemed to exist when the sum of the fractional ownership working interests in gross wells equals one. The number of net wells is the sum of the fractional working interest owned in gross wells.

At December 31, 2002, the Company was participating in the drilling of one gross (.1 net) well in the United States and three gross (2.8 net) wells in Canada.

DEVELOPED AND UNDEVELOPED ACREAGE

The following table sets forth the leasehold acreage held by the Company at December 31, 2002:

	Developed Acreage(1)		Undeveloped Acreage(2)	
	Gross(3)	Net(4)	Gross	Net
United States				
Permian Basin	17,201	4,664	8,150	3,550
Piceance and Uintah Basins	38,208	32,735	108,424	92,786
Montana	40	40	46,748	43,706
Wyoming	1,120	560	2,221	1,111
Total	56,569	37,999	165,543	141,153
Canada				
Alberta	48,480	27,448	27,360	21,564
Saskatchewan	1,520	432	160	40
Total	50,000	27,880	27,520	21,604

- (1)

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Developed acres are those acres which are spaced or assigned to productive wells.

- (2) Undeveloped acres are considered to be those acres on which wells have not been drilled or completed to a point that would permit the production of commercial quantities of oil and natural gas regardless of whether such acreage contains proved reserves. It should not be confused with undrilled acreage held by production under the terms of a lease.
- (3) A gross acre is an acre in which a working interest is owned. The number of gross acres is the total number of acres in which a working interest is owned.
- (4) A net acre is deemed to exist when the sum of the fractional ownership working interests in gross acres equals one. The number of net acres is the sum of the fractional working interests owned in gross acres.

The developed and undeveloped acreage position in the United States at December 31, 2002 included 17,201 gross (4,664 net) developed acres, and 8,150 gross (3,550 net) undeveloped acres attributed to lands located primarily in southeast New Mexico. These properties were sold in March 2003.

MARKETING

The Company sells natural gas, oil and natural gas liquids production from wells that it operates directly to purchasers including end users, marketers and refiners. Where the Company is not the operator of the well, it may directly market the production or it may contract to sell its share of production through the operator of the well.

The Company generally enters into short-term natural gas sales contracts and is typically paid a price based on the regional price set by the market place for natural gas deliveries to the regional interstate mainline transportation pipeline, a price which is generally less than the price set for natural gas deliveries to Henry Hub, the principal point for natural gas production in the Gulf Coast region of the United States and the point at which the price of the natural gas contract of the New York Mercantile Exchange (NYMEX) is set. The Company is typically paid on an index basis, net of mainline transportation charges incurred by the buyer. As of December 31, 2002, Carbon Canada is a party to various natural gas transportation contracts in Canada. Carbon Canada typically assigns these transportation contracts to the buyer of the Company's natural gas production for the term of the particular contract. The rights and obligations under these transportation agreements revert to the Company upon expiration of the natural gas sales contracts.

In the United States, oil is sold under contracts extending up to a year based upon monthly refiner price postings, which generally approximate the price of West Texas Intermediate crude oil adjusted to reflect transportation costs and quality. In Canada, oil and natural gas liquids are sold under short-term contracts at refiner posted prices for Alberta and Saskatchewan, adjusted to reflect transportation costs and quality.

For information regarding major purchasers of the Company's oil and natural gas, see Note 8 to the Consolidated Financial Statements.

COMPETITION

The oil and natural gas industry is highly competitive. The Company encounters competition from other oil and natural gas companies including major oil companies, other independent oil and natural gas concerns and individual producers and operators for the acquisition of producing properties and exploration and development prospects. The Company also competes with other oil and natural gas companies in attempting to secure drilling rigs and other equipment necessary for drilling and completion of wells. The Company competes with a large number of companies having substantially larger technical staffs and greater financial and operational resources. The ability of the Company to increase reserves in the future will be dependent on its ability to generate successful prospects on its existing lands, to acquire producing properties and to acquire additional leases and prospects for future development and exploration.

TITLE TO PROPERTIES

Title to the Company's properties is subject to royalty, overriding royalty, carried, net profits, working and similar interests customary in the oil and gas industry. The Company's properties may also be subject to liens incident to operating agreements, as well as other customary encumbrances, easements and restrictions and for current taxes not yet due. For acquisitions of properties, the Company will conduct a title examination on all material properties. Prior to the commencement of drilling operations, a title examination and, if necessary, curative work will be performed. The methods of title examination adopted by the Company are reasonable in the opinion of management and are designed to insure that production from its properties, if obtained, will be salable for the account of the Company.

GOVERNMENT REGULATION

United States

The Company's United States operations are regulated at the federal, state and local levels. Natural gas and oil exploration, development, production and marketing activities are subject to various laws and regulations which may be periodically changed for a variety of political, economical and other reasons.

In the past, the federal government has regulated the prices at which oil and natural gas could be sold. The Natural Gas Wellhead Decontrol Act of 1989 removed all price controls affecting producing wellhead sales effective January 1, 1993. While sales by producers of oil, natural gas, and natural gas liquids can currently be made at uncontrolled market prices, Congress could reenact price controls in the future. The Company's natural gas sales are affected by regulation of intrastate and interstate transportation. In recent years the Federal Energy Regulatory Commission (FERC) has issued a series of orders that has increased competition by, among other things, removing the transportation barriers to market access. These orders have had a significant impact upon gas markets in the United States and have fostered the development of a large spot market for gas and increased competition for gas markets. As a result of the FERC orders, producers can access gas markets directly but face increased competition for these markets. The Company believes that these changes have generally improved the Company's access to transportation and has enhanced the marketability of its natural gas production. To date the Company believes it has not experienced any material adverse effects as a result of these FERC orders; however the Company cannot predict what new regulations may be adopted by FERC and other regulatory authorities and the effect, if any, subsequent regulations may have on the Company.

The Company's oil and natural gas operations are regulated by administrative agencies under statutory provisions of the states where such operations are conducted and by certain agencies of the Federal government for operations on federal oil and gas leases. All of the jurisdictions in which the Company owns or operates producing oil and natural gas properties have statutory provisions regulating the exploration for and production of crude oil and natural gas. These statutes include the regulation of the size of drilling and spacing units and the number of wells which may be drilled in an area and the unitization or pooling of oil and natural gas properties. In addition, state conservation laws establish maximum rates of production from oil and natural gas wells, typically prohibit the venting or flaring of natural gas, and impose certain requirements regarding the apportionment of production from fields and individual wells. The effect of these regulations may limit the amount of oil and natural gas the Company can produce from its wells and limit the number of wells or location at which the Company can drill. State commissions establish rules for reclamation of sites, plugging bonds, reporting and other matters.

Increasingly, a number of city and county governments have enacted oil and natural gas regulations which have increased the involvement of local governments in the permitting of oil and natural gas operations and impart additional restrictions or conditions on the conduct of operators to mitigate the impact of operations on the local community. These local restrictions have the potential to delay and increase the cost of oil and natural gas operations.

Canada

The oil and natural gas industry in Canada is subject to extensive controls and regulations imposed by various levels of government. Federal authorities do not regulate the price of oil and gas in export trade but instead rely on market forces to establish these prices. Legislation exists that regulates the quantities of oil and natural gas which may be removed from the provinces and exported from Canada. The Company does not expect that any of these controls and regulations will affect the Company in a manner significantly different than other oil and natural gas companies of similar size.

The provinces in which the Company operates have legislation and regulation which govern land tenure, royalties, production rates and environmental protection. The royalty regime in the provinces in which the Company operates is a significant factor in the profitability of the Company's production. Crown royalties are determined by government regulation and are typically calculated as a percentage of the value of production. The value of the production and the rate of royalties payable depends on prescribed reference prices, well productivity, geographical location and the type or quality of the product produced.

In Alberta, the Company is entitled to a credit against Crown royalties on most of the properties in which the Company has an interest in by virtue of the Alberta Royalty Tax Credit (ARTC). The credit is determined by applying a rate to a maximum of CDN \$2.0 million of Crown royalties payable in Alberta for each company or associated group of companies. The rate is a function of the royalty tax credit par prices which is determined quarterly by the Alberta Department of Energy. The rate ranges from 25% to 75% depending upon petroleum prices for the previous quarter.

ENVIRONMENTAL REGULATION

United States

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The Company, as a lessee and operator of natural gas and oil properties, is subject to various federal, state and local laws and regulations in the United States that provide for restriction and prohibition on releases or emissions of various substances produced in association with certain oil and gas industry operations which can affect the location of wells and facilities and can determine the extent to which exploration and development is permitted. In addition, legislation requires that well and facility sites and access be abandoned and reclaimed to the satisfaction of federal or state authorities, as applicable. These laws and regulations may, among other things, impose liability and penalties on the lessee for the cost of pollution cleanup resulting from operations, subject the lessee to liability for pollution damages, require suspension or cessation of operations in affected areas, and impose restrictions on the injection of liquids into subsurface aquifers that may contaminate ground water.

The Company has made, and will continue to make, expenditures in its efforts to comply with environmental regulations. The Company believes it is in compliance with applicable environmental laws and regulations in effect and that continued compliance with existing requirements will not have a material adverse impact on the Company. The Company has not been notified of, nor has any knowledge of any existing or pending environmental claims. Changes in existing environmental laws or the adoption of new environmental laws could have the potential to adversely affect the Company's operations. In connection with the Company's acquisition of Carbon USA, environmental assessments of Carbon USA's oil and gas properties were performed. No material noncompliance or clean-up liabilities requiring action were discovered. However, environmental assessments were performed on only a percentage of the Company's properties according to the value of the properties established at the time of acquisition.

The Company believes that it is reasonably likely that the trend in environmental legislation and regulation will continue toward stricter standards. No assurance can be given as to future capital expenditures which may be required for compliance with prospective environmental regulations.

Canada

In Canada, the oil and natural gas industry is currently subject to environmental regulations pursuant to provincial and federal legislation. Environmental legislation provides for restrictions on releases or emissions of various substances produced or utilized in association with certain oil and gas industry operations. In addition, legislation requires that well and facility sites be abandoned and reclaimed to the satisfaction of provincial authorities. A breach of such regulations may result in the imposition of fines and penalties, the suspension of operations and potential civil liability. The Environmental Protection and Enhancement Act imposes environmental standards and requires compliance with various legislative criteria including reporting and monitoring in Alberta. The Alberta Energy and Utility Board, pursuant to its governing legislation, also plays a role with respect to the regulation of environmental impacts of oil and gas activities.

OPERATING HAZARDS

The oil and gas industry involves a variety of operating risks including the risk of fire, explosion, blow-outs, pipe failure, casing collapse, abnormally pressured formations, and environmental hazards such as oil spills, gas leaks, ruptures and discharge of toxic substances. The occurrence of any of these events might result in substantial losses to the Company due to injury and loss of life, severe damage to and destruction of property and natural resources and investigation and penalties and suspension of operations. The Company maintains insurance against some, but not all, potential risks. There can be no assurance that any such insurance that is obtained will be adequate to cover all losses or exposure for liability. Furthermore, the Company cannot predict whether such insurance will continue to be available at premium levels that justify its purchase.

ITEM 3. LEGAL PROCEEDINGS

Neither the Company nor its subsidiaries are engaged in any material legal proceedings.

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

None.

PART II

ITEM 5. MARKET FOR REGISTRANTS COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

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On February 24, 2000, Carbon Energy shares began trading on the American Stock Exchange under the trading symbol CRB. The Company's equity securities consist of common stock with no par value. The range of the high and low closing prices of the Company's common stock for each quarterly period during 2002 and 2001 is as follows:

Quarter Ended	High	Low
March 31, 2002	\$ 8.69	\$ 7.90
June 30, 2002	9.90	8.60
September 30, 2002	9.89	9.50
December 31, 2002	10.25	9.70
March 31, 2001	\$ 8.80	\$ 6.81
June 30, 2001	12.31	8.80
September 30, 2001	9.90	8.20
December 31, 2001	9.59	8.60

On March 19, 2003, the closing price of the common stock was \$10.50. There were approximately 40 holders of record of the common stock and 6.1 million shares outstanding.

The Company has not paid dividends on its common stock since inception and does not anticipate doing so in the future. Future payments of dividends, if any, will depend on the Company's earnings, capital requirements, loan restrictions, financial condition and other relevant factors. There is no assurance that the Company will ever pay dividends.

ITEM 6. SELECTED FINANCIAL DATA

The table below sets forth selected historical financial and operating data for Carbon and its predecessor, Bonneville Fuels, as of or for each of the years in the five-year period ended December 31, 2002. For 1999, the table presents the activities of the Company for November and December 1999 (the Company's operating activities prior to November 1, 1999 were minimal) and Carbon's predecessor, Bonneville Fuels, for the period January through October 1999, and a pro forma presentation for the combined operating and cash flow data for the year ended December 31, 1999. The twelve month figures as of or for the year ended December 31, 1998 are for Carbon's predecessor, Bonneville Fuels. Future results may differ substantially from historical results because of changes in oil and natural gas prices, production increases or declines and other factors. This information should be read in conjunction with the financial statements and notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations," presented elsewhere herein. Please see Note 7 and Note 14 to the Consolidated Financial Statements for information on geographic segments and quarterly data for 2002 and 2001.

	As of or for the Year Ended December 31,			Pro Forma for the	As of or for the	As of or for the	As of or for the
	2002	2001	2000	Year Ended December 31, 1999	Two Months Ended December 31, 1999	Ten Months Ended October 31, 1999	Year Ended December 31, 1998
(dollars in thousands, except per share data)							

Operating Data:

Revenues	\$ 18,071	\$ 23,069	\$ 17,649	\$ 11,136	\$ 1,915	\$ 9,221	\$ 7,912
Net earnings (loss)	(14,555)	1,573	1,456	147	(491)	638	(2,191)
Earnings (loss) per share:							
Basic	\$ (2.39)	\$ 0.26	\$ 0.25	n/a	(0.12)	n/a	n/a
Diluted	(2.39)	0.25	0.25	n/a			