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STORAGE TECHNOLOGY CORP
Form 10-Q
May 13, 2002

Form 10-Q

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended March 29, 2002
OR
 TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission File Number 1-7534

STORAGE TECHNOLOGY CORPORATION
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	84-0593263 (I.R.S. Employer Identification Number)
One StorageTek Drive, Louisville, Colorado (Address of principal executive offices)	80028-4309 (Zip Code)

Registrant's Telephone Number, including area code: (303) 673-5151

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. /X/ YES / / NO
-- --

APPLICABLE ONLY TO CORPORATE ISSUERS

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

Common stock (\$0.10 Par Value) - 105,914,764 shares outstanding as of May 6, 2002.

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STORAGE TECHNOLOGY CORPORATION AND SUBSIDIARIES
INDEX TO FORM 10-Q
March 29, 2002

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STORAGE TECHNOLOGY CORPORATION
CONSOLIDATED BALANCE SHEET
(In Thousands, Except Share Amounts)

	03/29/02	12/28/01
	-----	-----
ASSETS		
Current assets:	(Unaudited)	

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Cash and cash equivalents	\$ 484,461	\$ 453,217
Accounts receivable	446,030	505,630
Inventories	152,432	183,980
Deferred income tax assets	95,190	95,459
Other current assets	11,356	16,240
	-----	-----
Total current assets	1,189,469	1,254,526
Property, plant, and equipment	274,004	232,289
Spare parts for maintenance	37,169	35,674
Deferred income tax assets	121,153	121,826
Other assets	121,296	114,568
	-----	-----
Total assets	\$1,743,091	\$1,758,883
	=====	=====
LIABILITIES		
Current liabilities:		
Credit facilities	\$ --	\$ 73,401
Current portion of long-term debt	739	812
Accounts payable	69,942	66,648
Accrued liabilities	404,010	361,113
Income taxes payable	215,826	212,566
	-----	-----
Total current liabilities	690,517	714,540
Long-term debt	9,214	9,523
	-----	-----
Total liabilities	699,731	724,063
	-----	-----
Commitments and contingencies (Note 5)		
STOCKHOLDERS' EQUITY		
Common stock, \$0.10 par value, 300,000,000 shares authorized; 105,482,006 shares issued at March 29, 2002, and 105,032,665 shares issued at December 28, 2001	10,548	10,503
Capital in excess of par value	884,549	875,379
Retained earnings	156,086	150,129
Accumulated other comprehensive income	6,235	7,642
Treasury stock of 200,643 shares at March 29, 2002, and December 28, 2001, at cost	(3,777)	(3,777)
Unearned compensation	(10,281)	(5,056)
	-----	-----
Total stockholders' equity	1,043,360	1,034,820
	-----	-----
Total liabilities and stockholders' equity	\$1,743,091	\$1,758,883
	=====	=====

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

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STORAGE TECHNOLOGY CORPORATION
CONSOLIDATED STATEMENT OF OPERATIONS
(Unaudited)
(In Thousands, Except Per Share Amounts)

	Quarter Ended	
	03/29/02	03/30/01
Revenue		
Storage products	\$282,165	\$305,360
Storage services	173,747	163,459
	-----	-----
Total revenue	455,912	468,819
	-----	-----
Cost of revenue		
Storage products	160,816	173,615
Storage services	99,405	97,934
	-----	-----
Total cost of revenue	260,221	271,549
	-----	-----
Gross profit	195,691	197,270
Research and product development costs	54,505	64,194
Selling, general, administrative, and other income and expense, net	133,996	138,243
	-----	-----
Operating profit (loss)	7,190	(5,167)
Interest income	2,050	2,248
Interest expense	(483)	(1,635)
	-----	-----
Income (loss) before income taxes	8,757	(4,554)
Benefit (provision) for income taxes	(2,800)	1,550
	-----	-----
Net income (loss)	\$ 5,957	\$ (3,004)
	=====	=====
EARNINGS (LOSS) PER COMMON SHARE		
Basic earnings (loss) per common share	\$ 0.06	\$ (0.03)
	=====	=====

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Weighted-average shares	104,431 =====	102,274 =====
Diluted earnings (loss) per common share	\$ 0.06 =====	\$ (0.03) =====
Weighted-average and dilutive potential shares	107,449 =====	102,274 =====

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

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STORAGE TECHNOLOGY CORPORATION
CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited)
(In Thousands)

	Quarter Ended	
	03/29/02	03/30/01
	-----	-----
OPERATING ACTIVITIES		
Cash received from customers	\$512,530	\$572,250
Cash paid to suppliers and employees	(396,309)	(512,380)
Interest received	2,050	2,248
Interest paid	(483)	(1,451)
Income tax refunded (paid)	2,173	(1,985)
	-----	-----
Net cash provided by operating activities	119,961	58,682
	-----	-----
INVESTING ACTIVITIES		
Purchases of property, plant, and equipment	(10,872)	(16,818)
Proceeds from sale of property, plant, and equipment	6	76
Other assets	(7,354)	(3,078)
	-----	-----
Net cash used in investing activities	(18,220)	(19,820)
	-----	-----
FINANCING ACTIVITIES		
Proceeds from employee stock plans	2,862	--
Proceeds from other debt	178	588
Repayments of credit facilities, net	(73,401)	(16,421)
Repayments of other debt	(398)	(7,249)
	-----	-----
Net cash used in financing activities	(70,759)	(23,082)
	-----	-----
Effect of exchange rate changes on cash	262	(3,392)
	-----	-----
Increase in cash and cash equivalents	31,244	12,388
Cash and cash equivalents - beginning of the		

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period	453,217	279,731
	-----	-----
Cash and cash equivalents - end of the period	\$484,461	\$292,119
	=====	=====
RECONCILIATION OF NET INCOME (LOSS) TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Net income (loss)	\$ 5,957	\$ (3,004)
Depreciation and amortization expense	23,917	30,502
Inventory writedowns	7,832	5,881
Translation gain	(2,409)	(662)
Other non-cash adjustments to income	7,732	117
Decrease in accounts receivable	56,618	104,532
(Increase) decrease in other current assets	2,600	(7,860)
(Increase) decrease in inventories	25,253	(34,993)
(Increase) decrease in spare parts	(7,930)	4,130
(Increase) decrease in deferred income tax assets	997	(407)
Increase (decrease) in accounts payable	3,369	(11,230)
Decrease in accrued liabilities	(7,751)	(25,196)
Increase (decrease) in income taxes payable	3,776	(3,128)
	-----	-----
Net cash provided by operating activities	\$119,961	\$ 58,682
	=====	=====

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

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STORAGE TECHNOLOGY CORPORATION
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
(Unaudited)
(In Thousands)

	Quarter Ended	
	03/29/02	03/30/01
	-----	-----
Net income (loss)	\$ 5,957	\$ (3,004)
	-----	-----
Other comprehensive income (loss), net of tax:		
Cumulative effect of change in accounting principle on adoption of Statement of Financial Accounting Standards No. 133 and 138	--	(7,535)
Net gain (loss) on foreign currency cash flow hedges	(38)	18,194
Reclassification adjustment for net gains included in net income	(1,369)	(1,964)
	-----	-----
Other comprehensive income (loss), net of tax	(1,407)	8,695
	-----	-----
Comprehensive income	\$ 4,550	\$ 5,691
	=====	=====

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

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STORAGE TECHNOLOGY CORPORATION NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

NOTE 1 - BASIS OF PREPARATION

The accompanying interim consolidated financial statements of Storage Technology Corporation and its wholly owned subsidiaries (StorageTek or the Company) have been prepared on substantially the same basis as the Company's annual consolidated financial statements and should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 28, 2001. In the opinion of management, the interim consolidated financial statements reflect all adjustments necessary for the fair presentation of results for the periods presented, and such adjustments are of a normal, recurring nature.

The consolidated results for interim periods are not necessarily indicative of expected results for the full fiscal year.

NOTE 2 - INVENTORIES

Inventories, net of associated reserves, consist of the following (in thousands of dollars):

	03/29/02	12/28/01
Raw materials	\$ 28,874	\$ 41,850
Work-in-process	51,524	57,641
Finished goods	72,034	84,489
	-----	-----
	\$152,432	\$183,980
	=====	=====

NOTE 3 - GOODWILL

In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets." This statement addresses the accounting for goodwill and intangible assets subsequent to their acquisition. SFAS No. 142 requires that goodwill no longer be amortized. Under SFAS No. 142, goodwill will be tested for impairment on an annual basis or as necessary and written off if impaired. The Company adopted SFAS No. 142 on the first day of the Company's fiscal year 2002. The Company will complete the initial goodwill impairment test in the first half of 2002. An impairment charge is not currently anticipated to result from the completion of this impairment test.

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The following table presents the adjusted net income (loss) and earnings (loss) per share had SFAS No. 142 been in effect for all periods presented (in thousands, except per share amounts):

	Quarter Ended	
	03/29/02	03/30/01
Reported net income (loss)	\$ 5,957	\$ (3,004)
Add back: Goodwill amortization	--	1,457
Adjusted net income (loss)	\$ 5,957	\$ (1,547)
Basic earnings (loss) per common share:		
Reported net income (loss)	\$ 0.06	\$ (0.03)
Goodwill amortization	--	0.01
Adjusted net income (loss)	\$ 0.06	\$ (0.02)
Diluted earnings (loss) per common share:		
Reported net income (loss)	\$ 0.06	\$ (0.03)
Goodwill amortization	--	0.01
Adjusted net income (loss)	\$ 0.06	\$ (0.02)

NOTE 4 - DEBT AND FINANCING ARRANGEMENTS

The Company had a financing agreement with a bank that provided for the sale of promissory notes in the principal amount of up to \$75,000,000 at any one time. This agreement expired in January 2002, and all outstanding promissory notes under the agreement were repaid at that time. The Company has historically utilized foreign currency forwards embedded in borrowing commitments to hedge forecasted cash flows associated with revenue denominated in foreign currencies. The Company is currently using stand-alone foreign currency options and forwards in an attempt to mitigate the risk that forecasted cash flows associated with revenue denominated in foreign currencies may be adversely affected by changes in foreign currency exchange rates.

See the Company's Annual Report on Form 10-K for the year ended December 28, 2001, for additional information regarding the Company's debt and financing arrangements, and derivative instruments.

NOTE 5 - LITIGATION

In January 1994, Stuff Technology Partners II, a Colorado Limited Partnership (Stuff), filed suit in Boulder County, Colorado, District Court (the District Court) against the Company and certain subsidiaries. The suit alleged that the Company breached a 1990 settlement agreement that had resolved earlier litigation between the parties concerning an optical disk drive storage development project entered into in 1981 which was unsuccessful and terminated in 1985. The suit seeks injunctive relief and damages in the amount of \$2,400,000,000. In December 1995, the District Court granted the Company's motion for summary judgment and dismissed the complaint. Stuff appealed the dismissal to the Colorado Court of Appeals (the Court of Appeals). In March 1997, the Court of Appeals reversed the District Court's judgment and remanded the case to the District Court for further proceedings. In July 1999, the

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District Court again dismissed, with prejudice, all of Stuff's material claims against the Company. In August 1999, Stuff again appealed the dismissal to the Court of Appeals seeking to overturn the decision of the District Court. In August 2000, the Court of Appeals remanded the case back to the District Court for a trial on the factual issues relating to the interpretation of the language

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embodied in the 1990 settlement agreement. The Company filed a Petition for Rehearing with the Court of Appeals. In October 2000, the Court of Appeals denied the Company's Petition for Rehearing. In November 2000, the Company filed a Petition for Certiorari with the Supreme Court of Colorado (the Supreme Court). In April 2001, the Supreme Court denied the Company's petition. The case has been remanded to the District Court for trial. In July 2001, the parties stipulated to a bifurcated trial by first proceeding with a liability phase and, if Stuff were to prevail in the liability phase, a damages phase. A trial date for the first phase has been set for September 16, 2002. The Company continues to believe that Stuff's claims are wholly without merit and intends to defend vigorously any further actions arising from this complaint.

The Company also is involved in various other less significant legal actions. While the Company currently believes that the amount of any ultimate potential loss would not be material to the Company's financial position, the outcome of these actions is inherently difficult to predict. In the event of an adverse outcome, the ultimate potential loss could have a material adverse effect on the Company's financial position or reported results of operations in a particular quarter. An unfavorable decision, particularly in patent litigation, could require material changes in production processes and products or result in the Company's inability to ship products or components found to have violated third-party patent rights.

NOTE 6 - OPERATIONS OF BUSINESS SEGMENTS

The Company is organized into two reportable segments based on the definitions provided in SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information": storage products and storage services. The storage products segment includes sales of tape and tape automation products, disk products, and network products. The storage services segment includes maintenance and consulting services.

The Company does not have any intersegment revenue, and segment operating performance is evaluated based on gross profit. The aggregate gross profit by segment equals the consolidated gross profit, and the Company does not allocate research and product development costs; selling, general, administrative, and other income and expense; interest income; interest expense; or benefit (provision) for income taxes to the segments. The revenue and gross profit by segment is as follows (in thousands of dollars):

	Quarter Ended	
	03/29/02	03/30/01
Revenue:		
Storage products	\$282,165	\$305,360
Storage services	173,747	163,459
	-----	-----
Total revenue	\$455,912	\$468,819
	=====	=====

Gross profit:

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Storage products	\$121,349	\$131,745
Storage services	74,342	65,525
	-----	-----
Total gross profit	\$195,691	\$197,270
	=====	=====

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The following table provides supplemental financial data regarding revenue from the Company's storage products segment (in thousands of dollars):

	Quarter Ended	
	03/29/02	03/30/01
	-----	-----
Tape and tape automation products	\$227,167	\$247,437
Disk products	20,035	25,956
Network and other products	34,963	31,967
	-----	-----
Total storage products revenue	\$282,165	\$305,360
	=====	=====

NOTE 7 - EARNINGS (LOSS) PER COMMON SHARE

The following table presents the calculation of basic and diluted earnings (loss) per share (in thousands, except per share amounts):

	Quarter Ended	
	03/29/02	03/30/01
	-----	-----
Net income (loss)	\$ 5,957	\$ (3,004)
	=====	=====
Weighted average common shares outstanding:		
Basic	104,431	102,274
Effect of dilutive common stock equivalents	3,018	--
	-----	-----
Diluted	107,449	102,274
	=====	=====
Earnings (loss) per common share:		
Basic	\$ 0.06	\$ (0.03)
Diluted	\$ 0.06	\$ (0.03)

Options to purchase 4,238,371 shares of common stock as of March 29, 2002, were excluded from the computation of earnings per share because the exercise price of the options was greater than the average market price of the Company's common stock, and therefore, the effect would have been antidilutive. Options to purchase 10,969,742 shares of common stock as of March 30, 2001, were excluded from the computation of diluted earnings per share because they were antidilutive as a result of the net loss incurred in that period.

NOTE 8 - RECENT ACCOUNTING PRONOUNCEMENTS

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In August 2001, the FASB issued SFAS No. 143, "Accounting for Obligations Associated with the Retirement of Long-Lived Assets." This statement addresses the accounting for the recognition and measurement of an asset retirement obligation and its associated asset retirement cost. SFAS No. 143 is effective for the Company's financial statements for the year ending December 26, 2003. The adoption of this statement is not currently anticipated to have a material impact on the Company's financial position or results of operations.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This statement addresses the accounting for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. The Company adopted SFAS No. 144 on the first day of the

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Company's fiscal year 2002. The adoption of this statement did not have a material impact on the Company's financial position or results of operations.

NOTE 9 - SECONDARY STORAGE SERVICE AGREEMENT WITH EDS

On March 29, 2002, StorageTek and Electronic Data Systems Corporation (EDS) entered into a 10-year master secondary storage service agreement. Under the terms of the agreement, StorageTek will provide secondary storage services for certain EDS-operated data center sites within the United States. StorageTek will receive a fee for these services calculated using a monthly base service fee adjusted for certain increases and decreases in the actual amount of data stored. The agreement also provides for adjustments to the fees in the event specified service level metrics are not achieved.

The agreement can be renewed on an annual basis after the expiration of the initial 10-year term. The agreement can be cancelled by either party upon certain events, and can be cancelled by EDS for convenience with six months notice no sooner than two-and-one-half years from the effective date of the agreement. In the event EDS terminates the agreement for convenience, a termination fee is payable to StorageTek with the amount of the fee based upon a declining scale from the effective date.

In connection with this agreement, StorageTek acquired EDS' secondary storage equipment in these data center sites for a purchase price of \$52,200,000 and assumed certain pre-existing lease obligations of EDS totaling approximately \$6,400,000. The purchase price was paid in April 2002. Upon the expiration or termination of the agreement, EDS has the option to purchase any secondary storage equipment owned by StorageTek at the data center sites at a purchase price equal to the greater of the net book value of the equipment or the fair market value of the equipment. The purchase price payable to EDS has been recorded within property, plant, and equipment and accrued liabilities in the Consolidated Balance Sheet as of March 29, 2002. This preliminary purchase price allocation is subject to reclassification by the Company when finalized.

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MARCH 29, 2002

FORWARD-LOOKING STATEMENTS

All assumptions, anticipations, expectations and forecasts contained in the following discussion regarding the Company, its future products, business plans, financial results, performance and future events are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The Company's actual results may differ materially because of a number of risks and uncertainties. Some of these risks are detailed below in "Factors That May Affect Future Results" and elsewhere in this Form 10-Q. Forward-looking statements can be identified by the use of words such as "may," "will," "should," "expects," "plans," "anticipates," "believes," "estimates," "predicts," "intends," "potential," "continue," or the negative of such terms, or other comparable words. Forward-looking statements also include the assumptions underlying or relating to any such statements. The forward-looking statements contained herein represent a good-faith assessment of the Company's future performance for which management believes there is a reasonable basis. The Company disclaims any obligation to update the forward-looking statements contained herein, except as may be otherwise required by law.

CONSOLIDATED STATEMENT OF OPERATIONS DATA

The following table, stated as a percentage of total revenue, presents Consolidated Statement of Operations information and revenue by segment.

	Quarter Ended	
	03/29/02	03/30/01
Storage products:		
Tape and tape automation products	49.8%	52.8%
Disk products	4.4	5.5
Network and other products	7.7	6.8
Total storage products	61.9	65.1
Storage services	38.1	34.9
Total revenue	100.0	100.0
Cost of revenue	57.1	57.9
Gross profit	42.9	42.1
Research and product development costs	11.9	13.7
Selling, general, administrative, and other income and expense, net	29.4	29.5
Operating profit (loss)	1.6	(1.1)
Interest income (expense), net	0.3	0.1
Income (loss) before income taxes	1.9	(1.0)
Benefit (provision) for income taxes	(0.6)	0.4
Net income (loss)	1.3%	(0.6)%

REVENUE

STORAGE PRODUCTS

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The Company's storage products revenue consists of sales of tape and tape automation products, disk products, and network products for the mainframe and open-systems markets. The open-systems market consists of products designed to operate in the UNIX, NT, and other non-MVS operating environments. Storage product revenue decreased 8% during the first quarter of 2002, compared to the same period in 2001, primarily due to decreased revenue from tape and tape automation products.

Tape and Tape Automation Products

Tape and tape automation product revenue decreased 8% during the first quarter of 2002, compared to the same period in 2001, primarily due to decreased sales of tape automation products, including the Virtual Storage Manager(R) (VSM). The decrease is principally related to a reduction in the number of units sold. The Company believes this decline is primarily attributable to the current economic conditions and the associated weakness in information technology spending. These conditions were particularly prevalent in the Europe and Asia Pacific regions during the first quarter of 2002. The decreases were partially offset by increased revenue from mainframe and open-systems tape drive and media products. The ratio of tape drive sales to library sales increased during the quarter. The Company believes this increase is due to customers more fully utilizing the capacity of their existing libraries in order to minimize capital expenditures during the current economic environment.

Disk Products

Disk product revenue decreased 23% during the first quarter of 2002, compared to the same period in 2001, primarily due to decreased sales of the Shared Virtual Array(TM) (SVA) family of products. The decrease reflects both a reduction in the number of units sold and lower average selling prices. Disk revenue continues to be affected by pricing pressures and intense competition in the disk market, as well as the worldwide slowdown in customer spending for disk storage. The Company has not yet received any significant incremental sales revenue from its new distribution agreement with LSI Logic Storage Systems, which was announced in January 2002.

Network and Other Products

Network and other product revenue increased 9% during the first quarter of 2002, compared to the same period in 2001, primarily due to increased sales of storage area networking (SAN) hardware. This increase was partially offset by decreased sales of earlier-generation connectivity products.

STORAGE SERVICES

The Company's storage services revenue primarily includes revenue associated with the maintenance of the Company's and third-party storage products, as well as integration service revenue associated with storage consulting activities. Storage services revenue increased 6% during the first quarter of 2002, compared to the same period in 2001, primarily as a result of Company initiatives designed to provide end-to-end solutions that improve customer productivity and system availability.

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GROSS PROFIT

Gross profit margins increased to 43% for the first quarter of 2002, compared to 42% for the same period in 2001, primarily as a result of improvements in storage services profit margins. Gross profit margins for the storage products

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segment were unchanged at 43% for the first quarter of 2002, compared to the same period in 2001. Despite lower manufacturing volume in the first quarter of 2002, the Company improved its manufacturing operations and thus mitigated a portion of the unfavorable variances from lower production volumes. Gross margins for the storage services segment increased to 43% for the first quarter of 2002, compared to 40% for the same period in 2001. The increase reflects benefits from lower spare parts expense associated with maintenance services, as well as improvements in the service delivery process.

RESEARCH AND PRODUCT DEVELOPMENT

Research and product development expenses decreased 15% during the first quarter of 2002, compared to the same period in 2001, primarily due to engineering initiatives designed to improve research and development productivity, increase strategic alignment, and eliminate non-essential spending. The Company continues to evaluate and prioritize research and product development programs and is focusing on the core businesses of tape automation, virtual storage, SAN products, and related services.

SELLING, GENERAL, ADMINISTRATIVE, AND OTHER INCOME AND EXPENSE

Selling, general, administrative, and other income and expense (SG&A) decreased 3% during the first quarter of 2002, compared to the same period in 2001. As a percentage of revenue, SG&A was largely unchanged from the first quarter of 2001. The Company is continuing its efforts to control discretionary spending and identify new opportunities to drive increased profitability.

LITIGATION

In January 1994, Stuff Technology Partners II, a Colorado Limited Partnership (Stuff), filed suit in Boulder County, Colorado, District Court (the District Court) against the Company and certain subsidiaries. The suit alleged that the Company breached a 1990 settlement agreement that had resolved earlier litigation between the parties concerning an optical disk drive storage development project entered into in 1981 which was unsuccessful and terminated in 1985. The suit seeks injunctive relief and damages in the amount of \$2.4 billion. In December 1995, the District Court granted the Company's motion for summary judgment and dismissed the complaint. Stuff appealed the dismissal to the Colorado Court of Appeals (the Court of Appeals). In March 1997, the Court of Appeals reversed the District Court's judgment and remanded the case to the District Court for further proceedings. In July 1999, the District Court again dismissed, with prejudice, all of Stuff's material claims against the Company. In August 1999, Stuff again appealed the dismissal to the Court of Appeals seeking to overturn the decision of the District Court. In August 2000, the Court of Appeals remanded the case back to the District Court for a trial on the factual issues relating to the interpretation of the language embodied in the 1990 settlement agreement. The Company filed a Petition for Rehearing with the Court of Appeals. In October 2000, the Court of Appeals denied the Company's Petition for Rehearing. In November 2000, the Company filed a Petition for Certiorari with the Supreme Court of Colorado (the Supreme Court). In April 2001, the Supreme Court denied the Company's petition. The case has been remanded to the District Court for trial. In July 2001, the parties stipulated to a bifurcated trial by first proceeding with a liability phase and, if Stuff were to prevail in the liability phase, a damages phase. A trial date for the

first phase has been set for September 16, 2002. The Company continues to believe that Stuff's claims are wholly without merit and intends to defend vigorously any further actions arising from this complaint.

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The Company also is involved in various other less significant legal actions. While the Company currently believes that the amount of any ultimate potential loss would not be material to the Company's financial position, the outcome of these actions is inherently difficult to predict. In the event of an adverse outcome, the ultimate potential loss could have a material adverse effect on the Company's financial position or reported results of operations in a particular quarter. An unfavorable decision, particularly in patent litigation, could require material changes in production processes and products or result in the Company's inability to ship products or components found to have violated third-party patent rights.

INTEREST INCOME AND EXPENSE

Interest income decreased \$198,000 during the first quarter of 2002, compared to the same period in 2001, primarily as a result of lower interest rates. Interest expense decreased \$1.2 million during the first quarter of 2002, compared to the same period in 2001, primarily due to a decrease in outstanding debt.

INCOME TAXES

The Company's effective tax rate was 32% for the first quarter of 2002, compared to 34% for the same period in 2001. The decrease in the effective tax rate is primarily due to the Company's global tax strategies associated with the Company's manufacturing operations in Puerto Rico.

Statement of Financial Accounting Standards (SFAS) No. 109 requires that deferred income tax assets be recognized to the extent realization of such assets is more likely than not. Based on the currently available information, management has determined that the Company will more likely than not realize \$216.3 million of deferred income tax assets as of March 29, 2002. The Company's valuation allowance of approximately \$20.8 million as of March 29, 2002, relates principally to net deductible temporary differences, tax credit carryforwards, and net operating loss carryforwards.

RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets." This statement addresses the accounting for goodwill and intangible assets subsequent to their acquisition. SFAS No. 142 requires that goodwill no longer be amortized. Under SFAS No. 142, goodwill will be tested for impairment on an annual basis or as necessary and written off if impaired. The Company adopted SFAS No. 142 on the first day of the Company's fiscal year 2002. The Company will complete the initial goodwill impairment test in the first half of 2002. An impairment charge is not currently anticipated to result from the completion of this impairment test. See Note 3 for a discussion of the financial impact on the Company's results of operations had SFAS No. 142 been in effect for all periods presented.

In August 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 143, "Accounting for Obligations Associated with the Retirement of Long-Lived Assets." This statement addresses the accounting for the recognition and measurement of an asset retirement obligation and its associated asset retirement cost. SFAS No. 143 is effective for the Company's financial statements for the year ending December 26, 2003. The adoption of this statement

is not currently anticipated to have a material impact on the Company's

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financial position or results of operations.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This statement addresses the accounting for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. The Company adopted SFAS No. 144 on the first day of the Company's fiscal year 2002. The adoption of this statement did not have a material impact on the Company's financial position or results of operations.

LIQUIDITY AND CAPITAL RESOURCES

Working Capital

The Company's operating activities provided cash of \$120.0 million during the first quarter of 2002, compared to cash of \$58.7 million generated from operations during the same period in 2001. The increase in cash generated from operations during the first quarter of 2002, compared to the same period in 2001, was primarily a result of significantly lower purchases of inventory, as well as other efforts to more effectively manage working capital. Cash used in investing activities decreased from \$19.8 million during the first quarter of 2001 to \$18.2 million during the first quarter of 2002, primarily due to decreased spending on property, plant, and equipment. Cash used in financing activities increased to \$70.8 million during the first quarter of 2002, compared to \$23.1 million during the first quarter of 2001, primarily as a result of the repayment of borrowings under the Company's credit facilities, partially offset by increased proceeds from employee stock plans. The Company has continued to reduce its outstanding debt balance, and its debt-to-capitalization ratio was less than 1% as of March 29, 2002.

In connection with the secondary storage service agreement with EDS, the Company paid \$52.2 million to EDS in April 2002. See Note 9 for a discussion of the agreement with EDS.

Sources of Liquidity and Capitalization

The Company has a \$150.0 million revolving credit facility (the Revolver) that expires in October 2004. The interest rates for borrowing under the Revolver are dependent on the Company's Total Debt to rolling four quarter Earnings Before Interest Expense, Taxes, Depreciation, and Amortization (EBITDA) ratio and the term of the outstanding borrowing. The rate ranges from the applicable LIBOR plus 1.75% to 2.50% or the agent bank's base rate plus 0.00% to 0.50%. The Company had no outstanding borrowings under the Revolver as of March 29, 2002, but had outstanding letters of credit for approximately \$227,000. The remaining available credit under the Revolver as of March 29, 2002, was approximately \$149.8 million. The Revolver is secured by the Company's domestic accounts receivable and domestic inventory, and contains certain financial and other covenants, including restrictions on the payment of cash dividends on the Company's common stock.

The Company had a financing agreement with a bank that provided for the sale of promissory notes in the principal amount of up to \$75.0 million at any one time. This agreement expired in January 2002, and all outstanding promissory notes under the agreement were repaid at that time.

The Company's cash flows from operations are currently expected to serve as the principal source of working capital. Cash flows from operations could be negatively impacted by a decrease in demand for the Company's products and services as a result of rapid technological changes and other risks described under "Factors That May Affect Future Results."

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The Company believes it has adequate working capital and financing capabilities to meet its anticipated operating and capital requirements for the next 12 months. Over the longer term, the Company may choose to fund these activities through the issuance of additional debt or equity financing. The issuance of equity or convertible debt securities could result in dilution to the Company's stockholders. There can be no assurance that any additional long-term financing, if required, can be completed on terms that are favorable to the Company.

The Company's debt-to-capitalization ratio decreased from 7% as of December 28, 2001, to less than 1% as of March 29, 2002, primarily because of the repayment of borrowings under the Company's credit facilities. See "Working Capital," above, for discussion of cash sources and uses.

INTERNATIONAL OPERATIONS

International operations accounted for approximately 48% of the Company's revenue in the first quarter of 2002, compared to 49% in the same period of 2001. The Company also sells products through domestic indirect distribution channels that have end-user customers located outside the United States. The Company expects that it will continue to generate a significant portion of its revenue from international operations. The majority of the Company's international operations involve transactions denominated in the local currencies of countries within western Europe, principally Germany, France, and the United Kingdom; Australia; Canada; Japan; and Korea. An increase in the exchange value of the U.S. dollar reduces the value of revenue and profits generated by the Company's international operations. As a result, the Company's operating and financial results can be materially affected by fluctuations in foreign currency exchange rates. In an attempt to mitigate the impact of foreign currency fluctuations, the Company employs a foreign currency hedging program. See "Market Risk Management" below.

The Company's international business may be affected by changes in demand resulting from global and localized economic, business, and political conditions. The Company is subject to the risks of conducting business outside the United States, including adverse political and economic conditions; impositions of, or changes in, tariffs, quotas, and legislative or regulatory requirements; difficulty in obtaining export licenses; potentially adverse taxes; the burdens of complying with a variety of foreign laws; and other factors outside the Company's control. The Company expects these risks to increase in the future as it expands its operations in eastern Europe and Asia. There can be no assurance that these factors will not have a material adverse effect on the Company's business or financial results in the future.

MARKET RISK MANAGEMENT

Foreign Currency Exchange Rate Risk

The Company's primary market risk relates to changes in foreign currency exchange rates. The functional currency for the Company's foreign subsidiaries is the U.S. dollar. A significant portion of the Company's revenue is generated by its international operations. As a result, the Company's financial position, earnings, and cash flows can be materially affected by changes in foreign currency exchange rates. The Company attempts to mitigate this exposure as part of its foreign currency hedging program. The primary goal of the Company's foreign currency hedging program is to reduce the risk of adverse foreign currency movements on the reported financial results of its non-U.S. dollar transactions. Factors that could have an impact on the effectiveness of the Company's hedging program include the accuracy of forecasts and the volatility of foreign currency markets. All foreign currency derivatives are authorized and

executed pursuant to the Company's policies. The Company does not hold or issue derivatives for trading purposes.

To implement its foreign currency hedging program, the Company uses foreign currency options and forwards. These derivatives are used to hedge the risk that forecasted revenue denominated in foreign currencies might be adversely affected by changes in foreign currency exchange rates. Foreign currency forwards are also used to reduce the Company's exposure to foreign currency exchange rate fluctuations in connection with monetary assets and liabilities denominated in foreign currencies.

A hypothetical 10% adverse movement in foreign exchange rates applied to the Company's foreign currency exchange rate sensitive instruments held as of March 29, 2002, and as of December 28, 2001, would result in a hypothetical loss of approximately \$53.4 million and \$55.6 million, respectively. These hypothetical losses do not take into consideration the Company's underlying international operations. The Company anticipates that any hypothetical loss associated with the Company's foreign currency exchange rate sensitive instruments would be offset by gains associated with its underlying international operations.

Interest Rate Risk

Changes in interest rates affect interest income earned on the Company's cash investments, as well as interest expense on short-term borrowings. A hypothetical 10% adverse movement in interest rates applied to cash investments and short-term borrowings held as of March 29, 2002, and as of December 28, 2001, would not have a material adverse effect on the Company's financial position, earnings, or cash flows.

Credit Risk

The Company is exposed to credit risk associated with cash investments, foreign currency derivatives, and trade receivables. The Company does not believe that its cash investments and foreign currency derivatives present significant credit risks, because the counterparties to the instruments consist of major financial institutions, and the Company manages the notional amount of contracts entered into with any one counterparty. Substantially all trade receivable balances are unsecured. The concentration of credit risk with respect to trade receivables is limited due to the large number of customers in the Company's customer base and their dispersion across various industries and geographic areas. Although the Company has a large number of customers who are dispersed across different industries and geographic areas, a prolonged economic downturn could increase the Company's exposure to credit risk on its trade receivables. The Company performs ongoing credit evaluations of its customers and maintains an allowance for potential credit losses.

FACTORS THAT MAY AFFECT FUTURE RESULTS

New Products and Services

The Company's results of operations and competitive strength depend on its ability to successfully develop, manufacture, and market innovative new products and services. Short product life cycles are inherent in the high-technology market. The Company devotes significant resources to research and product development projects and must effectively manage the risks inherent in new product transitions. Developing new technologies, products, and services is complex and involves various uncertainties. In addition, the Company is still developing the necessary product modifications and professional services

knowledge to successfully implement its SAN solutions in various customer operating environments. Delays in product development, manufacturing, or in customer evaluation and purchasing decisions may make product transitions difficult. The manufacture of new products involves integrating complex designs and processes, collaborating with sole source suppliers for key components, and increasing manufacturing capacities to accommodate demand. A design flaw, the failure to obtain sufficient quantities of key components, or manufacturing constraints could adversely affect the Company's operating and financial results. The Company has experienced product development and manufacturing delays in the past that adversely affected its financial results and competitive position. There can be no assurance that the Company will be able to successfully manage the development and introduction of new products and services in the future.

Emerging Markets

Future revenue growth is partially dependent on successfully developing and introducing products for two primary emerging markets: the open-systems market and the SAN market.

The open-systems market includes products designed to operate in the UNIX, NT, and other non-MVS operating environments. Competition in the open-systems market is aggressive and is based on functionality, technology, performance, reliability, quality, system scalability, price, product availability, customer service, and brand recognition. The open-systems market encompasses a broad range of customers, including customers outside of the Company's traditional customer base. Many of the Company's potential customers in the open-systems market purchase their storage requirements as part of a bundled product, which may provide a competitive advantage to the Company's rivals. The Company expects to address these competitive factors through the delivery of storage solutions that provide customers with superior functionality, performance, and quality. The Company's customer base continues to shift to the open-systems market, and there can be no assurance that the Company's strategy will be effective in expanding its open-systems market sales.

The current and potential market for SAN solutions and technologies is continually evolving, and is characterized by rapidly changing technology and standards. New SAN solutions are continually being introduced by major server and storage providers. Customers may be reluctant to adopt new data storage standards, and competing standards may emerge that will be preferred by customers. Because this market is new and standards are still being defined, it is difficult to predict the potential size of the SAN market or the future rate of adoption of the Company's SAN solutions.

Competition

In the first quarter of 2002, approximately 81% of the Company's product sales revenue was derived from sales of tape and tape automation products. Additionally, a significant portion of the Company's service revenue is derived from the service of tape and tape automation products. One of the key competitive advantages that the Company's tape and tape automation products have over the competition's disk storage products is that the Company's tape and tape automation products store digitized data at a fraction of the cost of disk storage. The cost of disk storage continues to decrease at a rapid rate. The Company must continue to develop and introduce new tape and tape automation products that reduce the cost of storage at a rate that is similar to the decline in disk storage costs in order to maintain this competitive advantage.

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Strong competition has resulted in price erosion in the past, and the Company expects this trend to continue. The disk market has recently been subject to intense price competition. While the Company has unique competitive advantages

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with respect to its established customer base and a broad range of storage solution offerings, the Company's ability to compete in the disk market may be limited by the resources available for the further development of its disk products, as well as the ability to continue dropping the prices for its disk offerings to meet its competition.

Price competition for the Company's products and services may have a significant impact on the Company's gross profit margins. The Company's ability to sustain or improve total gross margins is significantly dependent on designing, developing, and manufacturing competitive products, as well as reducing costs associated with the sourcing of production materials. Storage product gross margins also may be affected in future periods by inventory reserves and writedowns resulting from rapid technological changes or delays in gaining market acceptance for products.

Indirect Channels

The Company continues to develop its indirect distribution channels, including original equipment manufacturers (OEMs), value-added distributors (VADs), value-added resellers (VARs), and other distributors. Increasing the Company's sales through these indirect channels is critical to the Company's successful expansion into the open-systems marketplace. There can be no assurance that the Company will be successful in expanding its indirect channel sales. Furthermore, there can be no assurance that profit margins on indirect channel sales will not deteriorate due to competitive pressures. Maintenance revenue also may be adversely affected in future periods to the extent that customers of these indirect channel partners elect to purchase maintenance services from vendors other than the Company.

The Company's ability to forecast future demand for its products may be adversely affected by unforeseen changes in demand from its indirect channel customers. The Company's worldwide indirect channel sales were adversely impacted during 2001 by the downturn in the economy. Although there was some improvement in U.S. indirect channel sales in the first quarter of 2002, the Company has limited visibility to future indirect channel sales and the future financial condition of its channel partners. The Company's financial results may be negatively affected if the financial condition of one or more of these channel partners weakens or if the current slowdown in customer spending continues.

Significant Personnel Changes

The Company has experienced significant changes in its executive management team during the last two years. There can be no assurance that future changes in the executive management team will not occur, and it may take a period of time before the new executive management team becomes fully effective.

The future success of the Company depends in large part on its ability to attract, retain, and motivate highly skilled employees. The Company faces significant competition for individuals who possess the skills required to design, develop, manufacture, and market the Company's products and services. An inability to successfully attract, retain, and motivate these employees could have an adverse effect on future operating results.

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Ability to Develop and Protect Intellectual Property Rights

The Company relies heavily on its ability to develop new intellectual property rights that do not infringe on the rights of others in order to remain competitive and to develop and manufacture products that are competitive in terms of technology and cost. There can be no assurance that the Company will continue to be able to develop such new intellectual property.

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The Company relies on a combination of U.S. patent, copyright, trademark, and trade secret laws to protect its intellectual property rights. With respect to certain of the Company's international operations, the Company files patent and trademark registration applications with foreign governments. However, many foreign countries do not have intellectual property laws that are as well developed as those of the United States. The Company enters into confidentiality agreements relating to its intellectual property with its employees and consultants. In addition, the Company includes confidentiality provisions in license and non-exclusive sales agreements with its customers.

Despite all of the Company's efforts to protect its intellectual property rights, unauthorized parties may attempt to copy or otherwise obtain or use the Company's intellectual property. Monitoring the unauthorized use of the Company's intellectual property rights is difficult, particularly in foreign countries. There can be no assurance that the Company will be able to protect its intellectual property rights, particularly in foreign countries.

Sole Source Suppliers

The Company generally uses standard parts and components for its products and believes that, in most cases, there are a number of alternative, competent vendors for most of those parts and components. Many nonstandard parts are obtained from a single source or a limited group of suppliers. However, there are other vendors who could produce these parts in satisfactory quantities after a period of prequalification and product ramping. Certain key components and products are purchased from sole source suppliers that the Company believes are currently the only manufacturers of the particular components that meet the Company's qualification requirements and other specifications or for which alternative sources of supply are not readily available. Imation Corporation is a sole source supplier for the 9840 and 9940 tape media, and the Company is dependent on Imation to economically produce large volumes of high-quality tape media at a cost acceptable to the Company and its customers. IBM was a sole source supplier for disk drives used in the Company's V960 and VSM products. As a result of IBM discontinuing the manufacture of these drives, the Company entered into a final purchase commitment with IBM based on forecasted requirements. The Company recognized inventory writedowns during 2001 related to the projected excess inventory levels of IBM disk drives obtained as part of the final purchase commitment. The Company is currently developing a standard industry drive interface for its virtual disk and tape products. This project is in the engineering and development stage. Failure to accurately forecast drive requirements or changes in the development schedule for the drive interface could result in additional inventory writedowns, or the inability to meet customer needs for these products.

Certain suppliers have experienced occasional technical, financial, or other problems that have delayed deliveries in the past. An unanticipated failure of any sole source supplier to meet the Company's requirements for an extended period, or the inability to secure comparable components in a timely manner, could result in a shortage of key components, longer lead times, and reduced control over production and delivery schedules. These factors could have a material adverse effect on revenue and operating results. In the event a sole

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source supplier was unable or unwilling to continue to supply components, the Company would need to identify and qualify other acceptable suppliers. This process could take an extended period, and no assurance can be given that any additional source would become available or would be able to satisfy production requirements on a timely basis or at a price acceptable to the Company.

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The Company is dependent on a sole subcontractor, Herald Datanetics Ltd. (HDL), to manufacture a key component used in certain tape products. HDL is located in the People's Republic of China (PRC). To date, the Company has not experienced any material problems with HDL. The Company's dependence on HDL is subject to additional risks beyond those associated with other sole suppliers, including the lack of a well-established court system or acceptance of the rule of law in the PRC, the degree to which the PRC permits economic reform policies to continue, the political relationship between the PRC and the United States, and broader political and economic factors.

Manufacturing

The Company manufactures a significant portion of its products in facilities located in Puerto Rico. The Company's ability to manufacture products may be affected by weather-related risks beyond the control of the Company. If the Puerto Rico manufacturing facility were affected by weather, the Company may not have an alternative source to meet the demand for its products without substantial delays and disruption to its operations. The Company carries interruption insurance to mitigate some of this risk. There is no assurance that the Company could obtain sufficient alternate manufacturing sources or repair the facilities in a timely manner to satisfy the demand for its products. Failure to fulfill manufacturing demands could adversely affect the Company's operating and financial results in the future.

From time to time, the Company has experienced delivery delays, increased lead times in ordering parts and components for its products, and rapid changes in the demand by customers for certain products. These longer lead times, coupled with rapid changes in the demand for products, could result in a shortage of parts and components, reduced control over delivery schedules, and an inability to fulfill customer orders in a timely manner. The complexities of these issues increase when the Company transitions to newer technologies and products. These factors could have a material adverse effect on revenue and operating results.

Earnings Fluctuations

The Company's financial and operating results may fluctuate from quarter to quarter for a number of reasons. Many of the Company's customers undertake detailed procedures relating to the evaluation, testing, implementation, and acceptance of the Company's products. This evaluation process results in a variable sales cycle and makes it difficult to predict if or when revenue will be earned. Furthermore, gross margins may be adversely impacted in an effort to complete the sales cycle.

In the past, the Company's results have followed a seasonal pattern, which reflects the tendency of customers to make their purchase decisions at the end of a calendar year. During any fiscal quarter, a disproportionately large percentage of the total product sales are earned in the last weeks or days of the quarter. This effect has been compounded by the recent slowdown in the global economy.

A number of other factors also may cause revenue to fall below expectations, such as product and technology transitions announced by the Company or its competitors, delays in the availability of new products, changes in the

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purchasing patterns of the Company's customers and distribution partners, or adverse global economic conditions. The mix of sales among the Company's business segments and sales concentration in particular geographic regions may carry different gross profit margins and may cause the Company's operating margins to fluctuate. These factors make the forecasting of revenue inherently difficult. Because the Company plans its operating expenses on expected revenue, a shortfall in revenue may cause earnings to be below expectations in that period.

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The Company's ability to generate revenue growth during 2001 and the first quarter of 2002 was adversely affected by the slowdown in the global economy as some customers delayed purchase decisions, reevaluated their information technology spending budgets, and reduced capital expenditures by maximizing the current capacities of their data storage equipment. In light of this economic environment, the Company has implemented various cost-saving measures, including reduced discretionary spending and delayed employee merit increases. There can be no assurance that a prolonged economic downturn will not have additional adverse effects on the Company's future revenue or operating results. Furthermore, there can be no assurance that these measures will be successful or sufficient to allow the Company to continue to generate improved operating results in future periods. It is possible that changes in the Company's business or its industry may necessitate restructuring activities in the future. The necessity for restructuring activities may result in expenses that adversely affect reported results of operations in the period the restructuring plan is adopted and may require incremental cash payments.

ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information required under this Item 3 is included in the section above entitled "Market Risk Management."

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STORAGE TECHNOLOGY CORPORATION AND SUBSIDIARIES PART II - OTHER INFORMATION

ITEM 1 - LEGAL PROCEEDINGS

In January 1994, Stuff Technology Partners II, a Colorado Limited Partnership (Stuff), filed suit in Boulder County, Colorado, District Court (the District Court) against the Company and certain subsidiaries. The suit alleged that the Company breached a 1990 settlement agreement that had resolved earlier litigation between the parties concerning an optical disk drive storage development project entered into in 1981 which was unsuccessful and terminated in 1985. The suit seeks injunctive relief and damages in the amount of \$2.4 billion. In December 1995, the District Court granted the Company's motion for summary judgment and dismissed the complaint. Stuff appealed the dismissal to the Colorado Court of Appeals (the Court of Appeals). In March 1997, the Court of Appeals reversed the District Court's judgment and remanded the case to the District Court for further proceedings. In July 1999, the District Court again dismissed, with prejudice, all of Stuff's material claims against the Company. In August 1999, Stuff again appealed the dismissal to the Court of Appeals seeking to overturn the decision of the District Court. In August 2000, the

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Court of Appeals remanded the case back to the District Court for a trial on the factual issues relating to the interpretation of the language embodied in the 1990 settlement agreement. The Company filed a Petition for Rehearing with the Court of Appeals. In October 2000, the Court of Appeals denied the Company's Petition for Rehearing. In November 2000, the Company filed a Petition for Certiorari with the Supreme Court of Colorado (the Supreme Court). In April 2001, the Supreme Court denied the Company's petition. The case has been remanded to the District Court for trial. In July 2001, the parties stipulated to a bifurcated trial by first proceeding with a liability phase and, if Stuff were to prevail in the liability phase, a damages phase. A trial date for the first phase has been set for September 16, 2002. The Company continues to believe that Stuff's claims are wholly without merit and intends to defend vigorously any further actions arising from this complaint.

In December 1999, the Company filed suit in the U.S. District Court for the Western District of Wisconsin against Cisco Systems, Inc. ("Cisco"), alleging that Cisco infringed on a certain patent of the Company that Cisco used in its products. The Company filed an amended complaint on December 30, 1999, in which the Company alleged that Cisco had infringed on a second patent used in its products. Cisco filed an answer in January 2000 denying the Company's claims, alleging that the Company's patents are invalid. In March 2000, the case was transferred to the U.S. District Court for the Northern District of California. In February 2002, the Court granted Cisco's motions for summary judgment of non-infringement. The Company has appealed that decision to the Court of Appeals for the Federal Circuit.

The Company also is involved in various other less significant legal actions. While the Company currently believes that the amount of any ultimate potential loss would not be material to the Company's financial position, the outcome of these actions is inherently difficult to predict. In the event of an adverse outcome, the ultimate potential loss could have a material adverse effect on the Company's financial position or reported results of operations in a particular quarter. An unfavorable decision, particularly in patent litigation, could require material changes in production processes and products or result in the Company's inability to ship products or components found to have violated third-party patent rights.

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ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

The exhibits listed below are filed as part of this Quarterly Report on Form 10-Q or are incorporated by reference into this Quarterly Report on Form 10-Q:

- 3.1 Restated Certificate of Incorporation of Storage Technology Corporation dated July 28, 1987 (previously filed as Exhibit 3.1 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)
- 3.2 Certificate of Amendment dated May 22, 1989, to the Restated Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.2 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)

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- 3.3 Certificate of Second Amendment dated May 28, 1992, to the Restated Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.3 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)
- 3.4 Certificate of Third Amendment dated May 21, 1999, to the Restated Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 25, 1999, filed on August 9, 1999, and incorporated herein by reference)
- 3.5 Restated Bylaws of Storage Technology Corporation, as amended through November 11, 1998 (previously filed as Exhibit 3.1 to the Company's Current Report on Form 8-K dated November 19, 1998, and incorporated herein by reference)
- 4.1 Specimen Certificate of Common Stock, \$0.10 par value of Registrant (previously filed as Exhibit (c)(2) to the Company's Current Report on Form 8-K dated June 2, 1989, and incorporated herein by reference)
- 10.1(1) Storage Technology Corporation Amended and Restated 1987 Employee Stock Purchase Plan, as amended (previously filed as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporated herein by reference)
- 10.2(1) Storage Technology Corporation Amended and Restated 1995 Equity Participation Plan (previously filed as Exhibit 10.6 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1999, filed on March 10, 2000, and incorporated herein by reference)
- 10.3(1) Storage Technology Corporation Management by Objective Bonus Plan (previously filed as Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 30, 2001, filed on May 14, 2001, and incorporated herein by reference)
- 10.4(1) Storage Technology Corporation Amended and Restated Stock Option Plan for Non-Employee Directors (previously filed as Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 28, 1996, filed on August 12, 1996, and incorporated herein by reference)
- 10.5(1) Storage Technology Corporation Flexible Option Plan, dated December 2001 (previously filed as Exhibit 10.5 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002 and incorporated herein by reference)
- 10.6(1) Agreement between the Company and Gary Francis, dated August 19, 1997 (previously filed as Exhibit 10.25 to the Company's Annual Report on Form 10-K for the fiscal year ended December 26, 1997, filed on March 6, 1998, and incorporated herein by reference)
- 10.7(1) CEO Employment Agreement, dated July 11, 2000, between the Company and Patrick J. Martin (previously filed as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2000, filed on August 11, 2000, and incorporated herein by reference)

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- 10.8(1) Severance Agreement, dated as of July 1, 2001, between the Company and Robert S. Kocol (previously filed as Exhibit 10.9 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.9(1) Restricted Stock Award Agreement, dated as of September 27, 2001, by and between the Company and Robert S. Kocol (previously filed as Exhibit 10.9 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002 and incorporated herein by reference)
- 10.10(1) Offer Letter, dated May 10, 2001, from the Company to Michael McLay (previously filed as Exhibit 10.17 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporate herein by reference)
- 10.11(1) Offer Letter, dated February 9, 2001, from the Company to Jill F. Kenney (previously filed as Exhibit 10.19 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 30, 2001, filed on May 14, 2001, and incorporated herein by reference)
- 10.12(1) Offer Letter, dated February 9, 2001, from the Company to Roger Gaston (previously filed as Exhibit 10.20 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 30, 2001, filed on May 14, 2001, and incorporated herein by reference)
- 10.13(1) Promissory Note, dated May 11, 2001, from Michael McLay to the Company, in the principal amount of \$390,000 (previously filed as Exhibit 10.23 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporated herein by reference)
- 10.14(1) Promissory Note, dated May 11, 2001, from Michael McLay to the Company, in the principal amount of \$160,000 (previously filed as Exhibit 10.24 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporated herein by reference)
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- 10.15(1) Form of LEAP Participation Agreement, dated April 30, 2001 (previously filed as Exhibit 10.25 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporated herein by reference)
- 10.16(1) Offer Letter, dated July 16, 2001, from the Company to Roy Perry (previously filed as Exhibit 10.28 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.17(1) Offer Letter, dated June 27, 2001, from the Company to Angel Garcia (previously filed as Exhibit 10.29 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.18(1) Letter Agreement, dated July 1, 2001, between the Company and Bruce Taafe (previously filed as Exhibit 10.30 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)

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- 10.19(1) Separation Agreement and Release, dated January 2, 2002, by and between the Company and Jeffrey Dumas (previously filed as Exhibit 10.19 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002 and incorporated herein by reference)
- 10.20(1) Offer Letter, dated December 10, 2001, between the Company and Thomas Major (previously filed as Exhibit 10.20 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002 and incorporated herein by reference)
- 10.21(1) Letter Agreement, dated July 31, 2001, between the Company and Pierre Cousin (previously filed as Exhibit 10.21 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002 and incorporated herein by reference)
- 10.22(1) Separation Agreement, dated March 31, 2001, between the Company and Gary Anderson (previously filed as Exhibit 10.22 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002 and incorporated herein by reference)
- 10.23 Credit Agreement, dated as of October 10, 2001, among the Company, the several financial institutions thereto, Bank of America, N.A., as letter of credit issuing bank and sole administrative agent for the Banks, Key Corporate Capital, Inc. as Documentation Agent, Fleet National Bank as Syndication Agent, and Banc of America Securities LLC as sole lead arranger and sole book manager (previously filed as Exhibit 10.13 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.24 Security Agreement, dated as of October 10, 2001, by and among the Company, Bank of America, N.A., as Collateral Agent for itself and other Secured Parties referred to therein (previously filed as Exhibit 10.14 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 27
- 10.25 Guaranty, dated as of October 10, 2001, by StorageTek Holding Corporation, in favor of the Banks party to a certain Credit Agreement and Bank of America, N.A., as Agent and Issuing Bank and Collateral Agent (previously filed as Exhibit 10.15 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.26 Contingent Multicurrency Note Purchase Commitment Agreement dated as of December 12, 1996, between the Company and Bank of America National Trust and Savings Association (filed as Exhibit 10.29 to the Company's Annual Report on Form 10-K for the year ended December 27, 1996, filed on March 7, 1997, and incorporated herein by reference)
- 10.27 Second Amendment to Second Amended and Restated Contingent Multicurrency Note Purchase Commitment Agreement dated November 20, 1998, between Bank of America National Trust and Savings Association and the Company (filed as Exhibit 10.19 to the Company's Annual Report on Form 10-K for the year ended December 25, 1998, filed on March 5, 1999, and incorporated herein by reference)

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- 10.28 Third Amendment to Second Amended and Restated Contingent Multicurrency Note Purchase Commitment Agreement dated August 13, 1999, between Bank of America National Trust and Savings Association and the Company (previously filed as Exhibit 10.19 to the Company's Annual Report on Form 10-K for the year ended December 31, 1999, filed on March 10, 2000, and incorporated herein by reference)
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- 10.30 Fifth Amendment to Second Amended and Restated Contingent Multicurrency Note Purchase Commitment Agreement dated August 15, 2000, between the Company and Bank of America, N.A. (previously filed as Exhibit 10.20 to the Company's Annual Report on Form 10-K for the year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)
- 10.31 Waiver to Second Amended and Restated Multicurrency Note Purchase Commitment Agreement, dated as of April 25, 2001, by and between the Company and Bank of America, N.A. (previously filed as Exhibit 10.22 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 30, 2001, filed on May 14, 2001, and incorporated herein by reference)
- 10.32(1,2) Form of Executive Severance Agreement
- 10.33(2) Master Service Agreement (MSA), between each of the Company, Electronic Data Systems Corporation, and EDS Information Services L.L.C., dated as of April 1, 2002
- 10.34(2) Authorization Letter #1 pursuant to the MSA, dated April 1, 2002
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- 10.35(2) Authorization Letter #2 pursuant to the MSA, dated April 1, 2002
- 10.36(2) Master Secondary Storage Services Agreement, between the Company and Electronic Data Systems Corporation, dated March 29, 2002
- (b) Reports on Form 8-K.
- None.
-

- 1 Contract or compensatory plan or arrangement in which directors and/or officers participate.
- 2 Indicates exhibit filed with this Quarterly Report on Form 10-Q.

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registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

STORAGE TECHNOLOGY CORPORATION
(Registrant)

May 13, 2002

/s/ ROBERT S. KOCOL

(Date)

Robert S. Kocol
Corporate Vice President
and Chief Financial Officer
(Principal Financial Officer)

May 13, 2002

/s/ THOMAS G. ARNOLD

(Date)

Thomas G. Arnold
Vice President and Corporate Controller
(Principal Accounting Officer)

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EXHIBIT INDEX

Exhibit No.	Description
-----	-----
3.1	Restated Certificate of Incorporation of Storage Technology Corporation dated July 28, 1987 (previously filed as Exhibit 3.1 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)
3.2	Certificate of Amendment dated May 22, 1989, to the Restated Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.2 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)
3.3	Certificate of Second Amendment dated May 28, 1992, to the Restated Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.3 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)
3.4	Certificate of Third Amendment dated May 21, 1999, to the Restated

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Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 25, 1999, filed on August 9, 1999, and incorporated herein by reference)

- 3.5 Restated Bylaws of Storage Technology Corporation, as amended through November 11, 1998 (previously filed as Exhibit 3.1 to the Company's Current Report on Form 8-K dated November 19, 1998, and incorporated herein by reference)
- 4.1 Specimen Certificate of Common Stock, \$0.10 par value of Registrant (previously filed as Exhibit (c)(2) to the Company's Current Report on Form 8-K dated June 2, 1989, and incorporated herein by reference)
- 10.1(1) Storage Technology Corporation Amended and Restated 1987 Employee Stock Purchase Plan, as amended (previously filed as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporated herein by reference)
- 10.2(1) Storage Technology Corporation Amended and Restated 1995 Equity Participation Plan (previously filed as Exhibit 10.6 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1999, filed on March 10, 2000, and incorporated herein by reference)
- 10.3(1) Storage Technology Corporation Management by Objective Bonus Plan (previously filed as Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 30, 2001, filed on May 14, 2001, and incorporated herein by reference)
- 10.4(1) Storage Technology Corporation Amended and Restated Stock Option Plan for Non-Employee Directors (previously filed as Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 28, 1996, filed on August 12, 1996, and incorporated herein by reference)
- 10.5(1) Storage Technology Corporation Flexible Option Plan, dated December 2001 (previously filed as Exhibit 10.5 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002 and incorporated herein by reference)
- 10.6(1) Agreement between the Company and Gary Francis, dated August 19, 1997 (previously filed as Exhibit 10.25 to the Company's Annual Report on Form 10-K for the fiscal year ended December 26, 1997, filed on March 6, 1998, and incorporated herein by reference)
- 10.7(1) CEO Employment Agreement, dated July 11, 2000, between the Company and Patrick J. Martin (previously filed as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2000, filed on August 11, 2000, and incorporated herein by reference)
- 10.8(1) Severance Agreement, dated as of July 1, 2001, between the Company and Robert S. Kocol (previously filed as Exhibit 10.9 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.9(1) Restricted Stock Award Agreement, dated as of September 27, 2001, by

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and between the Company and Robert S. Kocol (previously filed as Exhibit 10.9 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002 and incorporated herein by reference)

- 10.10(1) Offer Letter, dated May 10, 2001, from the Company to Michael McLay (previously filed as Exhibit 10.17 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporate herein by reference)
 - 10.11(1) Offer Letter, dated February 9, 2001, from the Company to Jill F. Kenney (previously filed as Exhibit 10.19 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 30, 2001, filed on May 14, 2001, and incorporated herein by reference)
 - 10.12(1) Offer Letter, dated February 9, 2001, from the Company to Roger Gaston (previously filed as Exhibit 10.20 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 30, 2001, filed on May 14, 2001, and incorporated herein by reference)
 - 10.13(1) Promissory Note, dated May 11, 2001, from Michael McLay to the Company, in the principal amount of \$390,000 (previously filed as Exhibit 10.23 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporated herein by reference)
 - 10.14(1) Promissory Note, dated May 11, 2001, from Michael McLay to the Company, in the principal amount of \$160,000 (previously filed as Exhibit 10.24 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporated herein by reference)
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- 10.15(1) Form of LEAP Participation Agreement, dated April 30, 2001 (previously filed as Exhibit 10.25 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporated herein by reference)
 - 10.16(1) Offer Letter, dated July 16, 2001, from the Company to Roy Perry (previously filed as Exhibit 10.28 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
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 - 10.19(1) Separation Agreement and Release, dated January 2, 2002, by and between the Company and Jeffrey Dumas (previously filed as Exhibit 10.19 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002 and incorporated herein by reference)

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- 10.20(1) Offer Letter, dated December 10, 2001, between the Company and Thomas Major (previously filed as Exhibit 10.20 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002 and incorporated herein by reference)
- 10.21(1) Letter Agreement, dated July 31, 2001, between the Company and Pierre Cousin (previously filed as Exhibit 10.21 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002 and incorporated herein by reference)
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- 10.23 Credit Agreement, dated as of October 10, 2001, among the Company, the several financial institutions thereto, Bank of America, N.A., as letter of credit issuing bank and sole administrative agent for the Banks, Key Corporate Capital, Inc. as Documentation Agent, Fleet National Bank as Syndication Agent, and Banc of America Securities LLC as sole lead arranger and sole book manager (previously filed as Exhibit 10.13 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
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Annual Report on Form 10-K for the year ended December 31, 1999, filed on March 10, 2000, and incorporated herein by reference)

- 10.29 Fourth Amendment to Second Amended and Restated Contingent Multicurrency Note Purchase Commitment Agreement dated January 5, 2000, between the Company and Bank of America, N.A. (previously filed as Exhibit 10.20 to the Company's Annual Report on Form 10-K for the year ended December 31, 1999, filed on March 10, 2000, and incorporated herein by reference)
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- 10.34(2) Authorization Letter #1 pursuant to the MSA, dated April 1, 2002
- 10.35(2) Authorization Letter #2 pursuant to the MSA, dated April 1, 2002

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- 10.36(2) Master Secondary Storage Services Agreement, between the Company and Electronic Data Systems Corporation, dated March 29, 2002

-
- 1 Contract or compensatory plan or arrangement in which directors and/or officers participate.
- 2 Indicates exhibits filed with this Quarterly Report on Form 10-Q.

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D align="center" valign="top">

Onshore and Other:

Alabama

Various 513 1,288 4,365 18,121

Louisiana

Various 356 4,714 6,848 38,335

Other States

Various 132 453 1,248 7,566

Total Net Proved Reserves

18,428 78,021 188,588 \$1,088,714

- (a) Represents the present value of future net cash flows before deduction of federal income taxes, discounted at 10%, attributable to estimated net proved reserves as of December 31, 2005, as set forth in the Company's reserve reports prepared by its independent petroleum reserve engineers, Huddleston & Co., Inc. of Houston, Texas.

- (b) Includes a reduction for estimated plugging and abandonment costs that is reflected as a liability on our balance sheet at December 31, 2005, in accordance with Statement of

Financial
Accounting
Standards
No. 143,
Accounting for
Asset
Retirement
Obligations
(SFAS 143).
See the Oil and
Gas Reserve
table for the
standardized
measure of
discounted
future net cash
flow which is a
required
calculation by
the SEC.

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Gulf of Mexico Deepwater

Entrada, Garden Banks Blocks 738/782/826/827

The Entrada discovery is located in approximately 4,500 feet of water in the Gulf of Mexico. Two wells and seven sidetracks have been drilled to date. The Entrada Area is characterized by a northwest plunging salt ridge with multiple stacked amplitudes trapped against the salt and various faults. We own a 20% working interest in this discovery with BP, the operator, holding the remaining working interest.

An integrated project team consisting of personnel from BP and Callon, along with Conoco-Phillips and Devon Energy Corporation, the owners of production facilities in nearby Garden Banks 783, are working on a front-end engineering design study to tie-back Entrada to the production facilities. Project sanction is targeted for the second half of 2006 with first production expected in 2008.

Medusa, Mississippi Canyon Blocks 538/582

Our Medusa deepwater discovery was announced in September 1999, after we drilled the initial test well in 2,235 feet of water to a total depth of 16,241 feet and encountered over 120 feet of pay in two intervals. Subsequent sidetrack drilling from the wellbore was used to determine the extent of the discovery and a second well was drilled in the first quarter of 2000 to further delineate the extent of the pay intervals. We own a 15% working interest, Murphy Exploration & Production Company (Murphy), the operator, owns a 60% working interest and ENI Deepwater, LLC, owns the remaining 25% working interest.

In 2001 a drilling program began which included four development wells and one sidetrack. The program included production casing being set on six wells to provide initial production take-points and was completed in the first half of 2002. The construction of a floating production system, spar, at Medusa was completed during the second quarter of 2003. The A-1 well was completed and tied into the spar and commenced production in late November 2003. The remaining five wells were completed and commenced production in 2004. Mississippi Canyon 538 #4, North Medusa, was drilled in 2003 and was temporarily abandoned after encountering 28 feet of net pay. The well bore was re-entered in the fourth quarter of 2004, sidetracked and reached an objective depth of 9,600 feet in January 2005. The sidetrack encountered 46 feet of net pay, was completed and commenced initial production in April 2005 at a gross rate of 5,000 barrels of oil equivalent per day.

During 2005 the field produced 8.1 Bcfe net to us which accounted for 43% of our total production. Due to hurricanes and tropical storms during 2005, Medusa was not productive for approximately 102 days. After repairs of damage to Medusa's facilities and third-party transmission lines and production facilities caused by Hurricane Katrina, production was restored in November 2005 and pre-hurricane rates were achieved during December 2005. Medusa produced at an average daily gross rate of 34,000 barrels of crude oil and 35 MMcf during January 2006.

In December 2003, we transferred our undivided 15% working interest in the spar production facilities to Medusa Spar LLC in exchange for cash proceeds of approximately \$25 million and a 10% ownership interest in the LLC. A detailed discussion of this transaction is included in Management's Discussion and Analysis of Financial Condition and Results of Operations- Off-Balance Sheet Arrangements .

Habanero, Garden Banks Block 341

During February 1999, the initial test well on our Habanero deepwater discovery encountered over 200 feet of net pay in two zones. Located in 2,000 feet of water, the well was drilled to a measured depth of

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21,158 feet. We own an 11.25% working interest in the well. The well is operated by Shell Deepwater Development Inc., which owns a 55% working interest, with the remaining working interest being owned by Murphy.

A field delineation program began in mid-year 2001, which included three sidetracks of the discovery well.

Production casing was set on this well through one of the sidetracks to the Habanero 52 oil and gas sand and the Habanero 55 gas sand. Also, a development well was drilled in the summer of 2003 which provides a take-point for production from the Habanero 52 oil sand. By means of a sub-sea completion and tie back to an existing production facility in the area operated by Shell, production from the Habanero 52 oil sand commenced in late November 2003 and from the Habanero 55 gas sand in January 2004. In July 2004 the #2 well producing the Habanero 52 oil sand developed mechanical difficulties with a subsurface control valve and was shut-in resulting in a significant loss of production. Repairs were completed and production was restored in late December 2004. In addition, the #1 well producing the Habanero 55 gas sand was recompleted to the Habanero 55 oil sand in December 2004.

During 2005 Habanero produced 3.5 Bcfe net to us which accounted for 19% of our total production. Due to hurricanes and tropical storms during 2005 the field was not productive for approximately 85 days. After repairs of damage primarily to third-party transmission lines and production facilities caused by Hurricane Rita, production was restored in November 2005 and pre-hurricane rates were achieved during December 2005. Habanero produced at an average daily gross rate of 12,000 barrels of crude oil and 17 MMcf during January 2006.

Gulf of Mexico Shelf

West Cameron Block 295

During the third quarter of 2005, the #2 well reached a total depth of 15,775 feet and logged 150 feet of net pay in two zones. Each zone was encountered at the predicted depth and exceeded anticipated thickness. First production from the #2 well is expected in the first half of March 2006 at a gross rate of approximately 30 MMcf per day. Callon holds a 20.5% working interest in the block and Hydro Gulf of Mexico, LLC is the operator.

A second prospect on this block was also drilled during 2005. The #3 well was drilled to a depth of 16,286 feet in December 2005 and logged 110 feet of net (94 feet true vertical depth) pay in two zones. Production is expected to commence during May 2006 at a gross rate of approximately 10 MMcf per day. Callon holds a 20.5% working interest in the block and Cimarex Energy Company is the operator.

High Island Block A-540

The #1 well was spud in November 2005 and reached a total depth of 9,450 feet the following month after logging 32 feet of net pay in the objective section. First production is scheduled to commence in July 2006 at an anticipated gross rate of approximately 11 MMcf per day. The company owns a 60% working interest and Walter Oil and Gas is the operator.

Mobile Blocks 953/955

We own a 100% working interest in these two blocks and we are the operator. In the fourth quarter of 2001, we initiated a production acceleration program for Mobile Blocks 952, 953 and 955, which were being produced through the Mobile Block 864 Unit facilities and were production constrained. An

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acceleration well was successfully drilled in the fourth quarter of 2001 and stand-alone production facilities were installed and production flow lines were rerouted to the new facilities. Production commenced through the new facilities in April 2002. In order to completely produce the proved reserves of the field we drilled a development well on Mobile Block 955 during the first quarter of 2004.

During 2005 the three wells on the blocks produced 2.5 Bcf of natural gas net to us which accounted for 13.2% of our total production. Due to hurricanes and tropical storms during 2005, two of the wells were not productive for approximately 48 days and one well was down for 136 days. After repairs of damages caused by Hurricane Katrina, the field produced at an average daily gross rate of 7 MMcf during January 2006.

Mobile Block 864 Unit

We operate the Mobile Block 864 Unit, in which we have a 66.4% working interest. The Unit has four producing wells, unit production facilities and covers portions of three blocks.

During 2005 the Unit produced 833 MMcf of natural gas net to us which accounted for 4.4% of our total production. Due to hurricanes and tropical storms during 2005, the Unit was not productive for approximately 48 days. After repairs of damages caused by Hurricane Katrina, production was restored in November 2005. The field produced at an average daily gross rate of 4 MMcf during January 2006.

North Padre Island Block 913

An exploratory well was drilled to a vertical depth of 8,082 feet in the fourth quarter of 2004 and found natural gas pay in multiple intervals. Currently, the well is being tied back to existing infrastructure on a nearby block. We are the operator and own a 50% working interest. First production is expected to commence in March 2006 at a gross rate of 15 MMcf per day. The initial production was delayed due to equipment availability problems caused by Hurricanes Katrina and Rita.

East Cameron Block 90

The #1 well reached total depth of 8,500 feet in January 2005 and encountered 42 feet of net pay at two intervals, including 34 feet in the primary objective. The well commenced initial production in December 2005 at a gross rate of 5 MMcf per day. Callon operates and owns a 61.7% working interest. The initial production was delayed due to equipment availability problems caused by Hurricanes Katrina and Rita.

High Island Block 119

An initial exploratory well and one development well were drilled and completed in 2004. First production began in the third quarter of 2004. An exploratory well in an offsetting fault block was spud late in the fourth quarter of 2004 and was completed in 2005. We own a 22% working interest and Kerr- McGee Oil and Gas Corporation is the operator.

These three wells produced 1.2 Bcfe of natural gas net to our interest during 2005 which accounted for 6.5% of our total production. Due to hurricanes and tropical storms during 2005, the field was not productive for approximately 102 days. After repairs of damages caused by Hurricane Rita, production was restored in January 2006. The field is currently producing at an average daily gross rate of 13.0 MMcfe.

Table of Contents**Oil and Gas Reserves**

The following table sets forth certain information about our estimated proved reserves as reported by Huddleston & Co., Inc. as of the dates set forth below.

	Years Ended December 31,		
	2005	2004	2003
	(In thousands)		
Proved developed:			
Oil (Bbls)	7,323	10,292	9,919
Gas (Mcf)	30,982	33,982	31,415
Mcf	74,921	95,735	90,926
Proved undeveloped:			
Oil (Bbls)	11,105	9,456	13,790
Gas (Mcf)	47,039	38,637	43,276
Mcf	113,667	95,373	126,017
Total proved:			
Oil (Bbls)	18,428	19,748	23,709
Gas (Mcf)	78,021	72,619	74,691
Mcf	188,588	191,108	216,943
Estimated pre-tax future net cash flows (a)	\$ 1,487,817	\$ 892,145	\$ 838,847
Pre-tax discounted present value (a)	\$ 1,088,714	\$ 612,595	\$ 570,463
Standardized measure of discounted future net cash flows(a)	\$ 837,552	\$ 515,893	\$ 519,026

(a) Includes a reduction for estimated plugging and abandonment costs that is reflected as a liability on our balance sheet at December 31, 2005, in accordance with SFAS 143.

Our independent reserve engineers, Huddleston & Co., Inc., prepared the estimates of the proved reserves and the future net cash flows and present value thereof attributable to such proved reserves. Reserves were estimated using oil and gas prices and production and development costs in effect on December 31 of each

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such year, without escalation, and were otherwise prepared in accordance with SEC regulations regarding disclosure of oil and gas reserve information.

There are numerous uncertainties inherent in estimating quantities of proved reserves, including many factors beyond our control or the control of the reserve engineers. Reserve engineering is a subjective process of estimating underground accumulations of oil and gas that cannot be measured in an exact manner. The accuracy of any reserve or cash flow estimate is a function of the quality of available data and of engineering and geological interpretation and judgment. Estimates by different engineers often vary, sometimes significantly. In addition, physical factors, such as the results of drilling, testing and production subsequent to the date of an estimate, as well as economic factors, such as an increase or decrease in product prices that renders production of such reserves more or less economic, may justify revision of such estimates. Accordingly, reserve estimates could be different from the quantities of oil and gas that are ultimately recovered.

We have not filed any reports with other federal agencies which contain an estimate of total proved net oil and gas reserves during our last fiscal year.

Present Activities and Productive Wells

The following table sets forth the wells we have drilled and completed during the periods indicated. All such wells were drilled in the continental United States primarily in federal and state waters in the Gulf of Mexico.

	Years Ended December 31,					
	2005		2004		2003	
	Gross	Net	Gross	Net	Gross	Net
Development:						
Oil	1	0.15			2	.23
Gas			2	1.22		
Non-productive						
Total	1	0.15	2	1.22	2	.23
Exploration:						
Oil					1	.15
Gas	7	2.42	2	.72		
Non-productive	4	1.25	5	1.24	1	.20
Total	11	3.67	7	1.96	2	.35

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The following table sets forth our productive wells as of December 31, 2005:

	Wells	
	Gross	Net
Oil:		
Working interest	39.00	3.75
Royalty interest	192.00	3.14
Total	231.00	6.89
Gas:		
Working interest	33.00	12.70
Royalty interest	209.00	1.58
Total	242.00	14.28

A well is categorized as an oil well or a natural gas well based upon the ratio of oil to gas reserves on a Mcfe basis. However, some of our wells produce both oil and gas. At December 31, 2005, we had no wells with multiple completions. At December 31, 2005, 1 gross (0.033 net) exploration oil well and 1 gross (0.205 net) exploration gas well were in progress.

Leasehold Acreage

The following table shows our approximate developed and undeveloped (gross and net) leasehold acreage as of December 31, 2005.

Location	Leasehold Acreage			
	Developed		Undeveloped	
	Gross	Net	Gross	Net
Louisiana	6,092	3,882	13,516	5,584
Texas	78		15,870	6,680
Other states			681	509
Federal waters	108,102	56,770	257,140	78,523
Total	114,272	60,652	287,207	91,296

As of December 31, 2005, we owned various royalty and overriding royalty interests in 1,336 net developed and 6,862 net undeveloped acres. In addition, we owned 4,309 developed and 121,691 undeveloped mineral acres.

Major Customers

Our production is sold generally on month-to-month contracts at prevailing prices. The following table identifies customers to whom we sold a significant percentage of our total oil and gas production during each of the 12-month periods ended:

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	2005	December 31, 2004	2003
Shell Trading Company	34%	30%	
Louis Dreyfus Energy Services	16%	23%	27%
Plains Marketing, L.P.	16%	13%	
Chevron Texaco Natural Gas	10%	6%	
Reliant Energy Services		6%	28%
Prior Energy Corporation			20%

Because alternative purchasers of oil and gas are readily available, we believe that the loss of any of these purchasers would not result in a material adverse effect on our ability to market future oil and gas production.

Title to Properties

We believe that the title to our oil and gas properties is good and defensible in accordance with standards generally accepted in the oil and gas industry, subject to such exceptions which, in our opinion, are not so material as to detract substantially from the use or value of such properties. Our properties are typically subject, in one degree or another, to one or more of the following:

royalties and other burdens and obligations, express or implied, under oil and gas leases;

overriding royalties and other burdens created by us or our predecessors in title;

a variety of contractual obligations (including, in some cases, development obligations) arising under operating agreements, farmout agreements, production sales contracts and other agreements that may affect the properties or their titles;

back-ins and reversionary interests existing under purchase agreements and leasehold assignments;

liens that arise in the normal course of operations, such as those for unpaid taxes, statutory liens securing obligations to unpaid suppliers and contractors and contractual liens under operating agreements;

pooling, unitization and communitization agreements, declarations and orders; and

easements, restrictions, rights-of-way and other matters that commonly affect property.

To the extent that such burdens and obligations affect our rights to production revenues, they have been taken into account in calculating our net revenue interests and in estimating the size and value of our reserves. We believe that the burdens and obligations affecting our properties are conventional in the industry for properties of the kind owned by us.

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ITEM 3. LEGAL PROCEEDINGS

We are a defendant in various legal proceedings and claims, which arise in the ordinary course of our business. We do not believe the ultimate resolution of any such actions will have a material affect on our financial position or results of operations.

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

There were no matters submitted to a vote of security holders during the fourth quarter of 2005.

Table of Contents**PART II.****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS**

Our common stock trades on the New York Stock Exchange under the symbol CPE. The following table sets forth the high and low sale prices per share as reported for the periods indicated.

	Quarter Ended	High	Low
2004:			
	First quarter	\$ 11.23	\$ 8.70
	Second quarter	14.27	10.15
	Third quarter	14.40	11.10
	Fourth quarter	14.72	12.30
2005:			
	First quarter	\$ 18.00	\$ 13.22
	Second quarter	16.12	12.42
	Third quarter	21.25	14.81
	Fourth quarter	22.29	16.65

As of March 2, 2006, there were approximately 4,179 common stockholders of record.

We have never paid dividends on our common stock and intend to retain our cash flow from operations, net of preferred stock dividends, for the future operation and development of our business. In addition, our primary credit facility and the terms of our outstanding subordinated debt prohibit the payment of cash dividends on our common stock.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth, as of the dates and for the periods indicated, selected financial information about us. The financial information for each of the five years in the period ended December 31, 2005 has been derived from our audited Consolidated Financial Statements for such periods. The information should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and Notes thereto. The following information is not necessarily indicative of our future results.

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CALLON PETROLEUM COMPANY
SELECTED HISTORICAL FINANCIAL INFORMATION
(In thousands, except per share amounts)

	Years Ended December 31,				
	2005	2004	2003	2002	2001
Statement of Operations Data:					
Operating revenues:					
Oil and gas sales	\$ 141,290	\$ 119,802	\$ 73,697	\$ 61,171	\$ 60,010
Operating expenses:					
Lease operating expenses	24,377	22,308	11,301	11,030	11,252
Depreciation, depletion and amortization	44,946	47,453	28,253	27,096	21,081
General and administrative	8,085	8,758	4,713	4,705	4,635
Accretion expense	3,549	3,400	2,884		
Derivative expense	6,028	1,371	535	708	
Total operating expenses	86,985	83,290	47,686	43,539	36,968
Income from operations	54,305	36,512	26,011	17,632	23,042
Other (income) expenses:					
Interest expense	16,660	20,137	30,614	26,140	12,805
Other (income)	(998)	(357)	(444)	(1,004)	(1,742)
Loss on early extinguishment of debt		3,004	5,573		
Gain on sale of pipeline				(2,454)	
Gain on sale of Enron derivatives				(2,479)	
Writedown of Enron derivatives					9,186
Total other (income) expenses	15,662	22,784	35,743	20,203	20,249
Income (loss) before income taxes	38,643	13,728	(9,732)	(2,571)	2,793
Income tax expense (benefit)	13,209	(6,697)	8,432	(900)	977
Income (loss) before Medusa Spar LLC and cumulative effect of change in accounting principle	25,434	20,425	(18,164)	(1,671)	1,816
Income (loss) on Medusa Spar LLC, net of tax	1,342	1,076	(8)		
Income (loss) before cumulative effect of change in in accounting principle	26,776	21,501	(18,172)	(1,671)	1,816
Cumulative effect of change in accounting principle, net of tax			181		

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Net income (loss)	26,776	21,501	(17,991)	(1,671)	1,816
Preferred stock dividends	318	1,272	1,277	1,277	1,277
Net income (loss) available to common shares	\$ 26,458	\$ 20,229	\$ (19,268)	\$ (2,948)	\$ 539

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CALLON PETROLEUM COMPANY
SELECTED HISTORICAL FINANCIAL INFORMATION
(In thousands, except per share amounts)

	Years Ended December 31,				
	2005	2004	2003	2002	2001
Net income (loss) available to common shares	\$ 26,458	\$ 20,229	\$ (19,268)	\$ (2,948)	\$ 539
Net income (loss) per common share:					
Basic:					
Net income (loss) available to common before cumulative effect of change in accounting principle	\$ 1.43	\$ 1.28	\$ (1.42)	\$ (.22)	\$.04
Cumulative effect of change in accounting principle, net of tax			.01		
Net income (loss) available to common	\$ 1.43	\$ 1.28	\$ (1.41)	\$ (.22)	\$.04
Diluted:					
Net income (loss) available to common before cumulative effect of change in accounting principle	\$ 1.28	\$ 1.22	\$ (1.42)	\$ (.22)	\$.04
Cumulative effect of change in accounting principle, net of tax			.01		
Net income (loss) available to common	\$ 1.28	\$ 1.22	\$ (1.41)	\$ (.22)	\$.04
Shares used in computing net income (loss) per common share:					
Basic	18,453	15,796	13,662	13,387	13,273
Diluted	20,883	17,678	13,662	13,387	13,366
Balance Sheet Data (end of period):					
Oil and gas properties, net	\$ 447,364	\$ 406,690	\$ 390,163	\$ 377,661	\$ 343,158
Total assets	\$ 533,776	\$ 457,523	\$ 496,032	\$ 410,613	\$ 372,095
Long-term debt, less current portion	\$ 188,813	\$ 192,351	\$ 214,885	\$ 248,269	\$ 161,733
Stockholders' equity	\$ 228,048	\$ 198,312	\$ 133,261	\$ 140,960	\$ 147,224

We use the full-cost method of accounting. Under this method of accounting, our net capitalized costs to acquire explore and develop oil and gas properties may not exceed the standardized measure of our proved reserves. If these capitalized costs exceed a ceiling amount, the excess is charged to expense.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is intended to assist in an understanding of our financial condition and results of operations. Our Consolidated Financial Statements and Notes thereto contain detailed information that should be referred to in conjunction with the following discussion. See Item 8. Financial Statements and Supplementary Data.

General

We have been engaged in the exploration, development, acquisition and production of oil and gas properties since 1950. Our revenues, profitability and future growth and the carrying value of our oil and gas properties are substantially dependent on prevailing prices of oil and gas and our ability to find, develop and acquire additional oil and gas reserves that are economically recoverable. Our ability to maintain or increase our borrowing capacity and to obtain additional capital on attractive terms is also influenced by oil and gas prices.

Significant events of our financial and operating results for the year ended December 31, 2005 included an increase in the borrowing base from \$60 million to \$70 million, production downtime in the third and fourth quarter associated with the tropical storm activity and the redemption of all our outstanding shares of \$2.125 Convertible Exchange Preferred Stock, Series A. As a result of the redemption, we will benefit from an annual cash savings of \$1.3 million in dividend payments.

We expect that planned 2006 capital expenditures of approximately \$125 million will be funded with cash flows from operations and supplemented, if necessary, with our senior secured credit facility which had \$62.5 million available on December 31, 2005. For a more detailed discussion of outstanding debt see Note 5 to our Consolidated Financial Statements.

Our estimated net proved oil and gas reserves decreased at December 31, 2005 to 188.6 Bcfe. This represents a decrease of 1% from previous year-end 2004 estimated proved reserves of 191.1 Bcfe. We produced 18.8 Mmcfe and had net reserve additions of 16.3 Mmcfe.

Prices for oil and gas are subject to large fluctuations in response to relatively minor changes in the supply of and demand for oil and gas, market uncertainty and a variety of additional factors beyond our control. These factors include weather conditions in the United States, the condition of the United States economy, the actions of the Organization of Petroleum Exporting Countries, governmental regulation, political stability in the Middle East and elsewhere, the foreign supply of crude oil and natural gas, the price of foreign imports and the availability of alternate fuel sources. Any substantial and extended decline in the price of crude oil or natural gas would have an adverse effect on our carrying value of our proved reserves, borrowing capacity, revenues, profitability and cash flows from operations. We use derivative financial instruments (see Note 6 to our Consolidated Financial Statements and Item 7A. Quantitative and Qualitative Disclosures About Market Risks) for price protection purposes on a limited amount of our future production and do not use them for trading purposes. On a Mcfe basis, natural gas represents approximately 58% of the budgeted 2006 production and 41% of proved reserves at year-end 2005.

Inflation has not had a material impact on us and is not expected to have a material impact on us in the future.

Table of Contents**Summary of Significant Accounting Policies**

On December 16, 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which is a revision of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123). SFAS 123R supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees , and amends Statement of Financial Accounting Standards No. 95, Statement of Cash Flows . Generally, the approach in SFAS 123R is similar to the approach described in SFAS 123. However, SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

In April 2005, the SEC delayed the effective date of SFAS 123R for public companies to no later than the beginning of the first fiscal year beginning after June 15, 2005. Early adoption will be permitted in periods in which financial statements have not yet been issued. SFAS 123R permits public companies to adopt its requirements using one of two methods below:

A modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123R for all share-based payments granted after the effective date and (b) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123R that remain unvested on the effective date; or

A modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

As permitted by SFAS 123, we currently account for share-based payments to employees using APB Opinion 25's intrinsic value method and, as such, generally recognize no compensation cost for employee stock options.

Accordingly, the adoption of SFAS 123R's fair value method could have a significant impact on our result of operations, although it will have no impact on our overall financial position. The impact of adoption of SFAS 123R cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had we adopted SFAS 123R in prior periods, the impact of that standard would have approximated the impact of SFAS 123 as described in the disclosure of pro forma net income and earnings per share in Note 2 to our Consolidated Financial Statements. We adopted SFAS 123R on January 1, 2006 using the modified prospective method.

Property and Equipment. We follow the full-cost method of accounting for oil and gas properties whereby all costs incurred in connection with the acquisition, exploration and development of oil and gas reserves, including certain overhead costs, are capitalized into the full-cost pool. The amounts we capitalize into the full-cost pool are depleted (charged against earnings) using the unit-of-production method. The full-cost method of accounting for our proved oil and gas properties requires that we make estimates based on assumptions as to future events which could change. These estimates are described below.

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Depreciation, Depletion and Amortization (DD&A) of Oil and Gas Properties. We calculate depletion by using the capitalized costs in our full-cost pool plus future development and abandonment costs (combined, the depletable base) and our estimated net proved reserve quantities. Capitalized costs added to the full-cost pool and other costs added to the depletable base include the following:

the cost of drilling and equipping productive wells, dry hole costs, acquisition costs of properties with proved reserves, delay rentals and other costs related to exploration and development of our oil and gas properties;

our payroll and general and administrative costs and costs related to fringe benefits paid to employees directly engaged in the acquisition, exploration and/or development of oil and gas properties as well as other directly identifiable general and administrative costs associated with such activities. Such capitalized costs do not include any costs related to our production of oil and gas or our general corporate overhead;

costs associated with properties that do not have proved reserves attributed to them are excluded from the full-cost pool. These unevaluated property costs are added to the full-cost pool at such time as wells are completed on the properties, the properties are sold or we determine these costs have been impaired. Our determination that a property has or has not been impaired (which is discussed below) requires that we make assumptions about future events;

our estimates of future costs to develop proved properties are added to the full-cost pool for purposes of the DD&A computation. We use assumptions based on the latest geologic, engineering, regulatory and cost data available to us to estimate these amounts. However, the estimates we make are subjective and may change over time. Our estimates of future development costs are periodically updated as additional information becomes available; and

prior to the adoption of SFAS 143, estimated costs to dismantle, abandon and restore a proved property were added to the full-cost pool for the purposes of DD&A. Subsequent to the adoption of SFAS 143, effective January 1, 2003, these costs are included in the full-cost pool. Such cost estimates are periodically updated as additional information becomes available. As discussed below specifically SFAS 143, beginning January 1, 2003, we changed the method for which we account for such costs.

Capitalized costs included in the full-cost pool are depleted and charged against earnings using the unit of production method. Under this method, we estimate our quantity of proved reserves at the beginning of each accounting period. For each barrel of oil equivalent produced during the period, we record a depletion charge equal to the amount included in the depletable base (net of accumulated depreciation, depletion and amortization) divided by our estimated net proved reserve quantities.

Because we use estimates and assumptions to calculate proved reserves (as discussed below) and the amounts included in the full-cost pool, our depletion calculations will change if the estimates and assumptions are not realized. Such changes may be material.

Ceiling Test. Under the full-cost accounting rules, capitalized costs included in the full-cost pool, net of accumulated depreciation, depletion and amortization (DD&A), cost of unevaluated properties and deferred income taxes, may not exceed the present value of our estimated future net cash flows from proved oil and gas reserves, discounted at 10%, plus the lower of cost or fair value of unproved properties included in the costs being amortized, net of related tax effects. These rules generally require that, in estimating future net cash flow, we assume that future oil and gas production will be sold at the unescalated market price for oil and gas received at the end of each fiscal quarter and that future costs to produce oil and gas will remain constant at the prices in effect at the end of the fiscal quarter. We are required to write-down and charge to

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earnings the amount, if any, by which these costs exceed the discounted future net cash flows, unless prices recover sufficiently before the date of our financial statements. Given the volatility of oil and gas prices, it is likely that our estimates of discounted future net cash flows from proved oil and gas reserves will change in the near term. If oil and gas prices decline significantly, even if only for a short period of time, it is possible that writedowns of oil and gas properties could occur in the future.

Estimating Reserves and Present Values. The estimates of quantities of proved oil and gas reserves and the discounted present value of such reserves at the end of each quarter are based on numerous assumptions which are likely to change over time. These assumptions include:

the prices at which we can sell our oil and gas production in the future. Oil and gas prices are volatile, but we are generally required to assume that they will not change from the prices in effect at the end of the quarter. In general, higher oil and gas prices will increase quantities of proved reserves and the present value of such reserves, while lower prices will decrease these amounts. Because our properties have relatively short productive lives, changes in prices will affect the present value more than quantities of oil and gas reserves;

the costs to develop and produce our reserves and the costs to dismantle our production facilities when reserves are depleted. These costs are likely to change over time, but we are required to assume that costs in effect at the end of the quarter will not change. Increases in costs will reduce oil and gas quantities and present values, while decreases in costs will increase such amounts. Because our properties have relatively short productive lives, changes in costs will affect the present value more than quantities of oil and gas reserves; and

the liability to pay royalties to the Mineral Management Service. See Note 7 of our Consolidated Financial Statements for a more detailed discussion of this potential liability.

In addition, the process of estimating proved oil and gas reserves requires that our independent and internal reserve engineers exercise judgment based on available geological, geophysical and technical information. We have described the risks associated with reserve estimation and the volatility of oil and gas prices, under *Risk Factors* .

Unproved Properties. Costs associated with properties that do not have proved reserves, including capitalized interest, are excluded from the full-cost pool. These unproved properties are included in the line item *Unevaluated properties excluded from amortization*. Unproved property costs are transferred to the full-cost pool when wells are completed on the properties or the properties are sold. In addition, we are required to determine whether our unproved properties are impaired and, if so, add the costs of such properties to the full-cost pool. We determine whether an unproved property should be impaired by periodically reviewing our exploration program on a property by property basis. This determination may require the exercise of substantial judgment by our management.

Asset Retirement Obligations. In June 2001, the FASB issued SFAS 143 effective for fiscal years beginning after June 15, 2002. SFAS 143 essentially requires entities to record the fair value of a liability for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. We adopted the statement on January 1, 2003 resulting in a cumulative effect of accounting change of \$181,000, net of tax. See Note 8 to our Consolidated Financial Statements.

Derivatives. We use derivative financial instruments for price protection purposes on a limited amount of our future production and do not use them for trading purposes. Such derivatives were accounted for in years prior to 2001 as hedges and have been recognized as an adjustment to oil and gas sales in the period in which they are related. We currently use the accounting treatment for derivatives specified under SFAS 133.

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See Note 6 to our Consolidated Financial Statements.

Income Taxes. We follow the asset and liability method of accounting for deferred income taxes prescribed by Statement of Financial Accounting Standards No. 109 (SFAS 109) Accounting for Income Taxes . The statement provides for the recognition of a deferred tax asset for deductible temporary timing differences, capital and operating loss carryforwards, statutory depletion carryforward and tax credit carryforwards, net of a valuation allowance . The valuation allowance is provided for that portion of the asset, for which it is deemed more likely than not, that it will not be realized.

SFAS 109 provides for the weighing of positive and negative evidence in determining whether it is more likely than not that a deferred tax asset is recoverable. We incurred losses in 2002 and 2003 and had losses on an aggregate basis for the three-year period ended December 31, 2003. Because of these cumulative losses we established a full valuation allowance of \$11.5 million as of December 31, 2003.

As a result of production from our first two deepwater projects starting in November 2003, as well as refinancing our highest cost debt in 2004, we achieved profitable operations and had income on an aggregate basis for the three-year period ended December 31, 2004. As a result, we reversed the valuation allowance in 2004 which had a balance of \$7.0 million as of December 31, 2004. See Note 3 to the Consolidated Financial Statements for further disclosure.

Liquidity and Capital Resources

Historically, our primary sources of capital have been cash flows from operations, borrowings from financial institutions and the sale of debt and equity securities. Net cash and cash equivalents decreased during 2005 to \$2.6 million, down \$0.7 million. Cash provided from operating activities during 2005 totaled \$74 million, up 4% from \$71 million in 2004. Dividends paid on preferred stock in 2005 were \$318,000.

On June 15, 2004, we closed on a three-year senior secured credit facility underwritten by Union Bank of California, N.A. The credit facility includes a borrowing base, determined by the lender, of \$70 million, which may be adjusted semi-annually and could increase to a maximum of \$175 million. As of December 31, 2005 there were no borrowings outstanding under the facility and we had an aggregate of \$7.5 million in outstanding letters of credit issued under the credit facility. These letters of credit secure obligations under the outstanding hedging contracts described in Note 6 to the Consolidated Financial Statements. The outstanding letters of credit reduce the amount available for borrowings under the credit facility. As a result, \$62.5 million was available for future borrowings under the credit facility as of December 31, 2005.

In December 2003 and March 2004, we closed on our 9.75% senior notes due 2010 in the aggregate principal amount of \$200 million. The net proceeds from these notes and the public offering of 3,450,000 shares of common stock in the second quarter of 2004 were used to restructure our debt that was maturing in 2004 and 2005. See Note 5 to the Consolidated Financial Statements for a more detailed discussion of our debt restructure.

The indenture governing our 9.75% senior notes due 2010 and our senior secured credit facility contain various covenants including restrictions on additional indebtedness and payment of cash dividends. In addition, our senior secured credit facility contains covenants for maintenance of certain financial ratios. We were in compliance with these covenants at December 31, 2005.

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Our oil and gas reserves as reported by Huddleston & Co., Inc. were 189 Bcfe of natural gas equivalents on December 31, 2005. Our cash flow from operations during 2005 was generated by the production of 18.8 Bcfe after incurring significant downtime at our major producing properties due to tropical storms and hurricanes during the last half of the year. Production of our reserves during 2006, without weather-related downtime, is projected to be higher than 2005 due to eight new discoveries scheduled to commence initial production during 2006 which will offset traditional declines from our current producing properties.

Our planned capital expenditures for 2006 total \$125 million. The current portion of our asset retirement obligation in the amount of \$21.7 million and capitalized interest and general and administrative expenses are included in the \$125 million. Capital expenditure plans for 2006 include:

- the completion and development of pre-2006 shelf discoveries;

- the discretionary drilling of approximately 18 shelf and onshore exploratory wells;

- drilling of three deepwater prospects;

- lease and seismic acquisition; and

- capitalized interest and overhead.

We believe that our operating cash flow and our credit facility will be adequate to meet our capital, debt repayment, and operating requirements for 2006. We fund our day-to-day operating expenses and capital expenditures from operating cash flows, supplemented as needed by borrowings under our credit facility. In addition, we have sold debt and equity in both public and private offerings in the past, and we expect that these sources of capital will continue to be available to us in the future. Because of the liquidity and capital resources alternatives available to us, including internally generated cash flows, our management believes that our short-term and long-term liquidity is adequate to fund operations, including our capital spending program, repayment of maturing debt and any amounts that may ultimately be paid in connection with contingencies.

Our cash flow, both in the short and long-term, is impacted by highly volatile oil and natural gas prices, production levels, industry trends impacting operating expenses and our ability to continue to acquire or find reserves at competitive prices. Cash flow forecasts for internal use by management are revised monthly in response to changing market conditions and production projections. We routinely adjust capital expenditure budgets within the planned total amount in response to the adjusted cash flow forecasts and market trends in drilling and acquisitions costs.

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The following table describes our outstanding contractual obligations (in thousands) as of December 31, 2005:

Contractual Obligations	Payments due by Period				
	Total	Less Than One Year	One-Three Years	Three-Five Years	More Than-Five Years
Senior Secured Credit Facility	\$	\$	\$	\$	\$
9.75% Senior Notes	200,000			200,000	
Capital lease (future minimum payments)	1,710	439	577	449	245
Throughput Commitments:					
Medusa Spar LLC	12,684	3,836	5,532	3,316	
Medusa Oil Pipeline	606	206	186	113	101
	\$ 215,000	\$ 4,481	\$ 6,295	\$ 203,878	\$ 346

Off-Balance Sheet Arrangements

In December 2003, we announced the formation of a limited liability company, Medusa Spar LLC, which now owns a 75% undivided ownership interest in the deepwater spar production facilities on our Medusa Field in the Gulf of Mexico. We contributed a 15% undivided ownership interest in the production facility to Medusa Spar LLC in return for approximately \$25 million in cash and a 10% ownership interest in the LLC. The LLC will earn a tariff based upon production volume throughput from the Medusa area. We are obligated to process our share of production from the Medusa Field and any future discoveries in the area through the spar production facilities. This arrangement allows us to defer the cost of the spar production facility over the life of the Medusa Field. Our cash proceeds were used to reduce the balance outstanding under our senior secured credit facility. The LLC used the cash proceeds from \$83.7 million of non-recourse financing and a cash contribution by one of the LLC owners to acquire its 75% interest in the spar. On December 31, 2005, \$47.0 million of the financing was outstanding. The balance of Medusa Spar LLC is owned by Oceanering International, Inc. and Murphy. We are accounting for our 10% ownership interest in the LLC under the equity method.

2005 Hurricane Activity

During 2005, we encountered numerous tropical storms and hurricanes which caused all of our fields located in the Gulf of Mexico area to be shut-in at various times during the year. Hurricanes Katrina and Rita, being the most devastating of these tropical weather systems, caused substantial downtime in the third and fourth quarter of 2005 which was primarily due to damage incurred to oil and gas transmission lines and production facilities owned by third parties.

Our major fields, Medusa, Habanero and Mobile Bay Blocks 863, 864, 907, 953 and 955, incurred damage; but the fields were repaired and brought back online in the fourth quarter of 2005. Our properties are insured and we expect to get reimbursed for most of our costs incurred for damage repairs, less our \$250,000 deductible per occurrence. We estimated that our cost to repair the hurricane damages will be approximately \$4.0 million. As of December 31, 2005, we had expensed \$1.2 million for damages related to tropical storms and hurricanes for deductibles and the costs of repairs not covered by our property insurance carrier.

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The tropical storms and hurricanes during 2005 had a significant impact on our cash flows from properties. Scheduled below are our major properties which incurred lost production days:

Field	Production Days Lost
Medusa	102
Habanero	85
Mobile Block 864 Unit	48
Mobile 953	48
Mobile 955	136
High Island 119	102

These properties account for 86% of our production for 2005. In addition, initial production from our recent discoveries at North Padre Island Block 913 and East Cameron Block 90 were delayed due to equipment availability problems. See **Significant Properties** for more detail by property.

We are in the process of negotiating our insurance renewal for the year ended March 31, 2007. We expect our insurance premiums to increase but can not estimate the amount at this time.

Table of Contents**Results of Operations**

The following table sets forth certain operating information with respect to our oil and gas operations for each of the three years in the period ended December 31, 2005.

	2005	December 31, 2004	2003
Production:			
Oil (MBbls)	1,837	1,736	268
Gas (MMcf)	7,768	11,387	12,315
Total production (MMcfe)	18,787	21,801	13,923
Average daily production (MMcfe)	51.5	59.6	38.1
Average sales price:			
Oil (per Bbl) (a)	\$ 41.61	\$ 28.71	\$ 28.72
Gas (per Mcf)	\$ 8.35	\$ 6.15	\$ 5.36
Total (per Mcfe)	\$ 7.52	\$ 5.50	\$ 5.29
Oil and Gas revenues (in thousands):			
Oil revenue	\$ 76,425	\$ 49,826	\$ 7,696
Gas revenue	64,865	69,976	66,001
Total	\$ 141,290	\$ 119,802	\$ 73,697
Oil and gas production costs (in thousands):			
Lease operating expenses	\$ 24,377	\$ 22,308	\$ 11,301
Additional per Mcfe data:			
Sales price	\$ 7.52	\$ 5.50	\$ 5.29
Lease operating expenses	1.30	1.02	.81
Operating margin	\$ 6.22	\$ 4.48	\$ 4.48
Depletion	\$ 2.39	\$ 2.18	\$ 2.03
Accretion	\$.19	\$.16	\$.21
General and administrative (net of management fees)	\$.43	\$.40	\$.34
(a) Below is a reconciliation of the average NYMEX price to the average realized sales price per barrel of oil:			
Average NYMEX oil price	\$ 56.57	\$ 41.38	\$ 31.08
Basis differential and quality adjustments	(8.45)	(4.60)	(1.94)
Transportation	(1.26)	(1.27)	(0.42)
Hedging	(5.25)	(6.80)	
Average realized oil price	\$ 41.61	\$ 28.71	\$ 28.72

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Comparison of Results of Operations for the Years Ended December 31, 2005 and 2004

Oil and Gas Revenues

Total oil and gas revenues increased 18% from \$119.8 million in 2004 to \$141.3 million in 2005 primarily due to pricing. Total production for 2005 decreased by 14% versus 2004 as a result of downtime associated with the tropical storm and hurricane activity in 2005.

Gas production during 2005 totaled 7.8 Bcf and generated \$64.9 million in revenues compared to 11.4 Bcf and \$70.0 million in revenues during the same period in 2004. Average gas prices realized for 2005 were \$8.35 per Mcf compared to \$6.15 per Mcf during the same period last year. The decrease in production was primarily due to significant downtime related to tropical storm and hurricane activity and the normal and expected decline in production from our Mobile area fields and older properties. See our discussion of Significant Properties for a more detailed discussion by property of this downtime.

Oil production during 2005 totaled 1,837,000 barrels and generated \$76.4 million in revenues compared to 1,736,000 barrels and \$49.8 million in revenues for the same period in 2004. Average oil prices realized in 2005 were \$41.61 per barrel compared to \$28.71 per barrel in 2004. Oil production increased during 2005 despite significant downtime resulting from tropical storms and hurricanes. The increase was primarily attributable to our deepwater property Medusa which began production in 2003 from a single well with five others being brought online during 2004 and all six producing during 2005. In addition, our North Medusa discovery was completed and initial production commenced through the field facilities in April 2005. See our discussion of Significant Properties for more detail regarding production and downtime.

Lease Operating Expenses

Lease operating expenses for 2005 increased by 9% to \$24.4 million compared to \$22.3 million for the same period in 2004. The increase was primarily due to lease operating expenses related to our deepwater discovery, Medusa, which had higher throughput charges as a result of higher production rates and the addition of our High Island Block 119 field, which began producing late in the third quarter of 2004.

In addition, lease operating expenses for 2005 included the costs of repairs to our properties for damages caused by tropical storms and hurricanes in the net amount of \$1.2 million. This amount covers the deductibles and an estimate of repairs not expected to be reimbursed by our property insurance carrier.

Depreciation, Depletion and Amortization

Depreciation, depletion and amortization for 2005 and 2004 were \$44.9 million and \$47.5 million, respectively. The 5% decrease was primarily due to lower production volumes for 2005 compared to 2004. The decrease was partially offset by a higher average depletion rate.

Accretion Expense

Accretion expense for 2005 and 2004 of \$3.5 million and \$3.4 million, respectively, represents accretion for our asset retirement obligations. The increase was due to the addition of plugging and abandonment obligations. See Note 8 to the Consolidated Financial Statements.

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General and Administrative

General and administrative expenses for 2005, net of amounts capitalized, were \$8.1 million compared to \$8.8 million incurred in 2004. There was a charge in general and administrative expenses of \$2.6 million in the first quarter of 2004 for the early retirement of two executive officers of the Company. The decrease was partially offset by reduced capitalized overhead for 2005 and a non-cash charge during the second quarter of 2005 for the accelerated vesting of performance shares in the amount of \$930,000 for an executive officer and two directors of the Company, two of whom are deceased.

Interest Expense

Interest expense decreased by 17% in 2005 to \$16.7 million compared to \$20.1 million in 2004. This decrease is primarily attributable to an equity offering completed in the second quarter of 2004 in which a portion of the proceeds were used to redeem \$33 million of 11% Senior Subordinated Notes .

Loss on Early Extinguishment of Debt

A loss of \$3.0 million was incurred in 2004 for the write-off of deferred financing costs, pre-payment premiums and bond discounts associated with the early extinguishment of debt.

Income Taxes

For 2005, we had an income tax expense of \$13.2 million compared to an income tax benefit of \$6.7 million in 2004. The income tax benefit for 2004 resulted primarily from the reversal of the valuation allowance established in 2003 against our deferred tax asset. As a result of production from the Company's first two deepwater projects starting in November 2003, as well as refinancing its highest cost debt in 2004, the Company achieved profitable operations and has income on an aggregate basis for the three-year period ended December 31, 2004 and the Company reversed the valuation allowance. See Note 3 to our Consolidated Financial Statements for a more detailed discussion.

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Comparison of Results of Operations for the Years Ended December 31, 2004 and 2003

Oil and Gas Revenues

Total production for 2004 increased by 57% versus 2003 and total oil and gas revenues increased 63% from \$73.7 million in 2003 to \$119.8 million in 2004. Increased production was primarily due to our deepwater discoveries, Medusa and Habanero, which began producing late in the fourth quarter of 2003.

Gas production during 2004 totaled 11.4 Bcf and generated \$70.0 million in revenues compared to 12.3 Bcf and \$66.0 million in revenues during the same period in 2003. Average gas prices realized for 2004 were \$6.15 per Mcf compared to \$5.36 per Mcf during the same period the previous year. The decrease in production was primarily due to downtime for Hurricane Ivan and the normal and expected decline in production from our Mobile area fields and older properties. These factors were partially offset by production from Medusa and Habanero.

Oil production during 2004 totaled 1,736,000 barrels and generated \$49.8 million in revenues compared to 268,000 barrels and \$7.7 million in revenues for the same period in 2003. Average oil prices realized in 2004 were \$28.71 per barrel compared to \$28.72 per barrel in 2003. The increase in production was due to the initial production from our deepwater discoveries, Medusa and Habanero. The production increase was offset slightly by downtime for Hurricane Ivan and normal and expected declines in production from older properties.

Lease Operating Expenses

Lease operating expenses for 2004 increased by 97% to \$22.3 million compared to \$11.3 million for the same period in 2003. The increase was primarily due to lease operating expenses related to our deepwater discoveries, Medusa and Habanero.

Depreciation, Depletion and Amortization

Depreciation, depletion and amortization for 2004 and 2003 were \$47.5 million and \$28.3 million, respectively. The 68% increase was primarily due to higher production volumes for 2004 compared to 2003.

Accretion Expense

Accretion expense for 2004 and 2003 of \$3.4 million and \$2.9 million, respectively, represents accretion for our asset retirement obligations. The increase was due to the addition of plugging and abandonment obligations. See Note 8 to the Consolidated Financial Statements.

General and Administrative

General and administrative expenses for 2004, net of amounts capitalized, were \$8.8 million compared to \$4.7 million incurred in 2003. There was a charge in general and administrative expenses of \$2.6 million in the first quarter of 2004 for the early retirement of two executive officers of the Company. Also reduced capitalized overhead, higher directors fees, and increased independent and internal audit costs resulting from the implementation of The Sarbanes-Oxley Act, Section 404 contributed to the increase in general and administrative expenses.

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Interest Expense

Interest expense decreased by 34% in 2004 to \$20.1 million compared to \$30.6 million in 2003. This is a result of lower debt levels and lower interest rates due to the restructuring of debt in December 2003 and during the six-month period ended June 30, 2004 in addition to an equity offering completed in the second quarter of 2004. In addition, amortization of deferred financing costs and bond discounts decreased due to the write-off of unamortized deferred financing costs and bond discounts associated with the early extinguishment of debt.

Loss on Early Extinguishment of Debt

A loss of \$3.0 million and \$5.6 million was incurred in 2004 and 2003, respectively. Both were incurred for the write-off of deferred financing costs, pre-payment premiums and bond discounts associated with the early extinguishment of debt.

Income Taxes

The income tax benefit of \$6.7 million in 2004 resulted primarily from the reversal of the valuation allowance established in 2003 against our deferred tax asset. As a result of production from the Company's first two deepwater projects starting in November 2003, as well as refinancing its highest cost debt in 2004, the Company achieved profitable operations and has income on an aggregate basis for the three-year period ended December 31, 2004 and the Company reversed the valuation allowance. See Note 3 to our Consolidated Financial Statements for a more detailed discussion.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

The Company's revenues are derived from the sale of its crude oil and natural gas production. Recently the prices for oil and gas have increased; however, they remain extremely volatile and sometimes experience large fluctuations as a result of relatively small changes in supplies, weather conditions, economic conditions and government actions. The Company enters into short-term derivative financial instruments to hedge oil and gas price risks for the production volumes to which the hedge relates. The derivatives reduce the Company's exposure on the hedged volumes to decreases in commodity prices and limit the benefit the Company might otherwise have received from any increases in commodity prices on the hedged volumes.

The Company also enters into price collars to reduce the risk of changes in oil and gas prices. Under these arrangements, no payments are due by either party so long as the market price is above the floor price set in the collar and below the ceiling. If the price falls below the floor, the counter-party to the collar pays the difference to the Company and if the price is above the ceiling, the counter-party receives the difference from the Company. Another type of hedging contract Callon has entered into is a put contract. Under a put, if the price falls below the set floor price, the counter-party to the contract pays the difference to the Company. The Company enters into these various agreements to reduce the effects of volatile oil and gas prices and does not enter into hedge transactions for speculative purposes. See Note 6 to the Consolidated Financial Statements for a description of the Company's hedged position at December 31, 2005. There have been no significant changes in market risks faced by the Company since the end of 2005.

Based on projected annual sales volumes for 2006 (excluding forecast production increases over 2005), a 10% decline in the prices Callon receives for its crude oil and natural gas production would have an approximate \$18 million impact on our revenues.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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Report of Independent Registered Public Accounting Firm

The Stockholders and Board of Directors

Callon Petroleum Company

We have audited the accompanying consolidated balance sheets of Callon Petroleum Company as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Callon Petroleum Company as of December 31, 2005 and 2004, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the financial statements, effective January 1, 2003, the Company adopted Statement of Financial Accounting Standards No. 143, Accounting for Asset Retirement Obligations.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Callon Petroleum Company's internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 9, 2006, expressed an unqualified opinion thereon.

/s/Ernst & Young LLP

New Orleans, Louisiana

March 9, 2006

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CALLON PETROLEUM COMPANY
CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

	December 31,	
	2005	2004
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 2,565	\$ 3,266
Accounts receivable	33,195	14,928
Deferred tax asset-current	26,770	5,676
Restricted investments-current	4,110	2,055
Fair market value of derivatives	889	1,570
Other current assets	1,998	581
Total current assets	69,527	28,076
Oil and gas properties, full-cost accounting method:		
Evaluated properties	937,698	862,101
Less accumulated depreciation, depletion and amortization	(539,399)	(494,453)
	398,299	367,648
Unevaluated properties excluded from amortization	49,065	39,042
Total oil and gas properties	447,364	406,690
Other property and equipment, net	1,605	1,541
Deferred tax asset		2,986
Long-term gas balancing receivable	403	725
Restricted investments	1,858	5,687
Investment in Medusa Spar LLC	11,389	9,787
Other assets, net	1,630	2,031
Total assets	\$ 533,776	\$ 457,523
 LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 39,323	\$ 15,728
Fair market value of derivatives	1,247	2,993
Undistributed oil and gas revenues	721	1,162
Accrued net profits interest payable		1,927
Suspended Medusa oil royalties		5,430
Asset retirement obligations-current	21,660	13,300
Current maturities of long-term debt	263	576

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Total current liabilities	63,214	41,116
Long-term debt	188,813	192,351
Asset retirement obligations	16,613	24,982
Deferred tax liability	31,633	
Accrued liabilities to be refinanced	5,000	
Other long-term liabilities	455	762
Total liabilities	305,728	259,211
Stockholders' equity:		
Preferred Stock, \$.01 par value; 2,500,000 shares authorized; -0- and 596,671 shares of Convertible Exchangeable Preferred Stock, Series A issued and outstanding at December 31, 2005 and 2004, respectively		6
Common Stock, \$.01 par value; 30,000,000 shares authorized; 19,357,138 shares and 17,616,596 shares issued and outstanding at December 31, 2005 and 2004, respectively	194	176
Unearned compensation-restricted stock	(3,334)	(5,352)
Capital in excess of par value	220,360	220,664
Other comprehensive loss	(331)	(1,883)
Retained earnings (deficit)	11,159	(15,299)
Total stockholders' equity	228,048	198,312
Total liabilities and stockholders' equity	\$ 533,776	\$ 457,523

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

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Callon Petroleum Company
Consolidated Statements of Operations
For the Years Ended December 31, 2005, 2004 and 2003
(In thousands, except per share amounts)

	2005	2004	2003
Operating revenues:			
Oil and gas sales	\$ 141,290	\$ 119,802	\$ 73,697
Operating expenses:			
Lease operating expenses	24,377	22,308	11,301
Depreciation, depletion and amortization	44,946	47,453	28,253
General and administrative	8,085	8,758	4,713
Accretion expense	3,549	3,400	2,884
Derivative expense	6,028	1,371	535
Total operating expenses	86,985	83,290	47,686
Income from operations	54,305	36,512	26,011
Other (income) expenses:			
Interest expense	16,660	20,137	30,614
Other (income)	(998)	(357)	(444)
Loss on early extinguishment of debt		3,004	5,573
Total other (income) expenses	15,662	22,784	35,743
Income (loss) before income taxes	38,643	13,728	(9,732)
Income tax expense (benefit)	13,209	(6,697)	8,432
Income (loss) before Medusa Spar LLC and cumulative effect of change in accounting principle	25,434	20,425	(18,164)
Income (loss) on Medusa Spar LLC, net of tax	1,342	1,076	(8)
Income (loss) before cumulative effect of change in accounting principle	26,776	21,501	(18,172)
Cumulative effect of change in accounting principle, net of tax			181
Net income (loss)	26,776	21,501	(17,991)
Preferred stock dividends	318	1,272	1,277
Net income (loss) available to common shares	\$ 26,458	\$ 20,229	\$ (19,268)

Net income (loss) per common share:

Basic

Net income (loss) available to common before cumulative effect of change in accounting principle	\$ 1.43	\$ 1.28	\$ (1.42)
Cumulative effect of change in accounting principle, net of tax			0.01
Net income (loss) available to common share	\$ 1.43	\$ 1.28	\$ (1.41)

Diluted

Net income (loss) available to common before cumulative effect of change in accounting principle	\$ 1.28	\$ 1.22	\$ (1.42)
Cumulative effect of change in accounting principle, net of tax			0.01
Net income (loss) available to common share	\$ 1.28	\$ 1.22	\$ (1.41)

Shares used in computing net income (loss) per share amounts:

Basic	18,453	15,796	13,662
Diluted	20,883	17,678	13,662

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

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CALLON PETROLEUM COMPANY
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
(In thousands)

	Preferred Stock	Common Stock	Unearned Restricted Stock Compensation	Capital in Excess of Par Value	Accumulated Other Comprehensive Income (Loss)	Retained Earnings (Deficit)	Total Stock- holders Equity
Balances, December 31, 2002	\$ 6	\$ 139	\$ (826)	\$ 158,370	\$ (469)	\$ (16,260)	\$ 140,960
Comprehensive income (loss):							
Net loss						(17,991)	
Other comprehensive income					449		
Total comprehensive loss							(17,542)
Preferred stock dividends						(1,277)	(1,277)
Shares issued pursuant to employee benefit and option plan		1		427			428
Employee stock purchase plan				127			127
Restricted stock		(1)	454	(516)			(63)
Warrants				10,628			10,628
Balances, December 31, 2003	6	139	(372)	169,036	(20)	(35,528)	133,261
Comprehensive income (loss):							
Net income						21,501	
Other comprehensive (loss)					(1,863)		
Total comprehensive income							19,638
Preferred stock dividend						(1,272)	(1,272)
Sale of common stock		35		44,012			44,047
Shares issued pursuant to employee benefit and option plan		1		720			721
Employee stock purchase plan		1		208			209
Tax benefits related to stock compensation plans				1,214			1,214
Restricted stock			(4,980)	5,474			494
Balances, December 31, 2004	6	176	(5,352)	220,664	(1,883)	(15,299)	198,312
Comprehensive income (loss):							
Net income						26,776	
Other comprehensive income					1,552		

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Total comprehensive income							28,328
Preferred stock dividend						(318)	(318)
Conversion of preferred shares to common stock	(6)	13		(643)			(636)
Shares issued pursuant to employee benefit and option plan		1		(325)			(324)
Employee stock purchase plan				(33)			(33)
Tax benefits related to stock compensation plans				1,029			1,029
Restricted stock	2	2,018		(330)			1,690
Warrants	2			(2)			

Balances, December 31, 2005 \$ \$ 194 \$ (3,334) \$ 220,360 \$ (331) \$ 11,159 \$ 228,048

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

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CALLON PETROLEUM COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2005, 2004 and 2003
(In thousands)

	2005	2004	2003
Cash flows from operating activities:			
Net income (loss)	\$ 26,776	\$ 21,501	\$ (17,991)
Adjustments to reconcile net income (loss) to cash provided by operating activities:			
Depreciation, depletion and amortization	45,657	48,164	29,264
Accretion expense	3,549	3,400	2,884
Amortization of deferred financing costs	2,062	1,929	6,568
Non-cash loss on extinguishment of debt		2,910	4,423
Income from investment in Medusa Spar, LLC	(1,342)	(1,076)	
Cumulative effect of change in accounting principle			(181)
Non-cash derivative expense	1,635	(135)	487
Deferred income tax expense (benefit)	13,209	(6,697)	8,432
Non-cash charge related to compensation plans	1,906	1,225	858
Changes in current assets and liabilities:			
Accounts receivable, trade	(11,169)	(4,495)	(1,438)
Other current assets	670	971	(2,667)
Current liabilities	(8,666)	2,903	5,185
Change in gas balancing receivable	322	376	(340)
Change in gas balancing payable	(289)	400	(491)
Change in other long-term liabilities	(18)	(20)	(15)
Change in other assets, net	(292)	(448)	(349)
Cash provided by operating activities	74,010	70,908	34,629
Cash flows from investing activities:			
Capital expenditures	(73,072)	(64,649)	(50,705)
Distribution from Medusa Spar, LLC	463	339	24,908
Proceeds from sale of pipeline and other facilities			1,500
Proceeds from sale of mineral interests			982
Cash used by investing activities	(72,609)	(64,310)	(23,315)
Cash flows from financing activities:			
Change in accrued liabilities to be refinanced	5,000		(3,861)
Increase in debt	7,000	90,000	198,000
Payments on debt	(12,000)	(205,915)	(133,000)
Restricted cash		63,345	(63,345)
Debt issuance cost		(984)	(3,745)
Issuance of common stock	2	44,047	
Buyout of preferred stock	(637)		
Equity issued related to employee stock plans	(573)	199	127

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Capital leases	(576)	(1,452)	(1,320)
Cash dividends on preferred stock	(318)	(1,272)	(1,277)
Cash used by financing activities	(2,102)	(12,032)	(8,421)
Net increase (decrease) in cash and cash equivalents	(701)	(5,434)	2,893
Cash and short-term investments:			
Balance, beginning of period	3,266	8,700	5,807
Balance, end of period	\$ 2,565	\$ 3,266	\$ 8,700

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

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**CALLON PETROLEUM COMPANY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

1. ORGANIZATION

General

Callon Petroleum Company (the Company or Callon) was organized under the laws of the state of Delaware in March 1994 to serve as the surviving entity in the consolidation and combination of several related entities (referred to herein collectively as the Constituent Entities). The combination of the businesses and properties of the Constituent Entities with the Company was completed on September 16, 1994 (Consolidation).

As a result of the Consolidation, all of the businesses and properties of the Constituent Entities are owned (directly or indirectly) by the Company. Certain registration rights were granted to the stockholders of certain of the Constituent Entities. See Note 7.

The Company and its predecessors have been engaged in the acquisition, development and exploration of crude oil and natural gas since 1950. The Company s properties are geographically concentrated in Louisiana, Alabama and offshore Gulf of Mexico.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Reporting

The Consolidated Financial Statements include the accounts of the Company, and its subsidiary, Callon Petroleum Operating Company (CPOC). CPOC also has subsidiaries, namely Callon Offshore Production, Inc. and Mississippi Marketing, Inc. All intercompany accounts and transactions have been eliminated. Certain prior year amounts have been reclassified to conform to presentation in the current year.

Use of Estimates

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 and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Asset Retirement Obligations

In June 2001, the FASB issued Statement of Financial Accounting Standards No. 143, Accounting for Asset Retirement Obligations (SFAS 143), effective for fiscal years beginning after June 15, 2002. SFAS 143 essentially requires entities to record the fair value of a liability for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. Callon adopted SFAS 143 on January 1, 2003 resulting in a cumulative effect of accounting change of \$181,000, net of tax. See Note 8.

Table of Contents**Oil and Gas Properties**

The Company follows the full-cost method of accounting for oil and gas properties whereby all costs incurred in connection with the acquisition, exploration and development of oil and gas reserves, including certain overhead costs, are capitalized. Such amounts include the cost of drilling and equipping productive wells, dry hole costs, lease acquisition costs, delay rentals, interest capitalized on unevaluated leases and other costs related to exploration and development activities. General and administrative costs capitalized include salaries and related fringe benefits paid to employees directly engaged in the acquisition, exploration and/or development of oil and gas properties as well as other directly identifiable general and administrative costs associated with such activities. Such capitalized costs (\$7.1 million in 2005, \$7.2 million in 2004 and \$8.4 million in 2003) do not include any costs related to production or general corporate overhead. Costs associated with unevaluated properties, including capitalized interest on such costs, are excluded from amortization. Unevaluated property costs are transferred to evaluated property costs at such time as wells are completed on the properties, the properties are sold or management determines that these costs have been impaired.

Costs of properties, including future development and future site restoration, dismantlement and abandonment costs, which have proved reserves and properties which have been determined to be worthless, are depleted using the unit-of-production method based on proved reserves. If the total capitalized costs of oil and gas properties, net of accumulated amortization and deferred taxes relating to oil and gas properties, exceed the sum of (1) the estimated future net revenues from proved reserves at current prices discounted at 10% and (2) the lower of cost or market of unevaluated properties (the full-cost ceiling amount), net of tax effects, then such excess is charged to expense during the period in which the excess occurs. See Note 9.

Upon the acquisition or discovery of oil and gas properties, management estimates the future net costs to be incurred to dismantle, abandon and restore the property using available geological, engineering and regulatory data. Such cost estimates are periodically updated for changes in conditions and requirements. Such estimated amounts are considered as part of the full-cost pool subject to amortization upon acquisition or discovery. Until January 1, 2003, such costs were capitalized as oil and gas properties as the actual restoration, dismantlement and abandonment activities took place. As discussed above under Asset Retirement Obligations, beginning January 1, 2003, the Company changed the method for which we account for such costs upon adoption of SFAS 143 and these costs are now capitalized to the full cost pool when the related liabilities are incurred in accordance with the provisions of SFAS 143. In accordance with the SEC issued Staff Accounting Bulletin No. 106, assets recorded in connection with the recognition of an asset retirement obligation pursuant to SFAS 143 are included as part of the costs subject to the full-cost ceiling limitation. The future cash outflows associated with settling the recorded asset retirement obligations are excluded from the computation of the present value of estimated future net revenues used in applying the ceiling test.

Property and Equipment

Depreciation of other property and equipment is provided using the straight-line method over estimated lives of three to 20 years. Depreciation of pipeline and other facilities is provided using the straight-line method over estimated lives of 15 to 27 years. Depreciation expense of \$227,000, \$346,000 and \$578,000 relating to other property and equipment was included in general and administrative expenses in the Company's statements of operations for the years ended December 31, 2005, 2004 and 2003, respectively. The accumulated depreciation on other property and equipment was \$10.6 million and \$10.4 million as of December 31, 2005 and 2004, respectively.

Table of Contents**Investment in Medusa Spar LLC**

In December 2003, the Company announced the formation of a limited liability company, Medusa Spar LLC, which now owns a 75% undivided ownership interest in the deepwater spar production facilities on Callon's Medusa Field in the Gulf of Mexico. The Company contributed a 15% undivided ownership interest in the production facility to Medusa Spar LLC in return for approximately \$25 million in cash and a 10% ownership interest in the LLC. The LLC will earn a tariff based upon production volume throughput from the Medusa area. Callon is obligated to process our share of production from the Medusa Field and any future discoveries in the area through the spar production facilities. This arrangement allows Callon to defer the cost of the spar production facility over the life of the Medusa Field. The Company's cash proceeds were used to reduce the balance outstanding under its senior secured credit facility. The LLC used the cash proceeds from \$83.7 million of non-recourse financing and a cash contribution by one of the LLC owners to acquire its 75% interest in the spar. On December 31, 2005, \$47.0 million of the financing was outstanding. The balance of Medusa Spar LLC is owned by Oceaneering International, Inc. (NYSE:OII) and Murphy Oil Corporation (NYSE:MUR). The Company is accounting for our 10% ownership interest in the LLC under the equity method.

Natural Gas Imbalances

The Company follows the entitlement method of accounting for its proportionate share of gas production on a well-by-well basis, recording a receivable to the extent that a well is in an "undertake" position and conversely recording a liability to the extent that a well is in an "overtake" position. Gas balancing receivables were \$403,000 and \$725,000 as of December 31, 2005 and 2004, respectively. Gas balancing payables were \$304,000 and \$594,000 as of December 31, 2005 and 2004, respectively.

Derivatives

The Company uses derivative financial instruments for price protection purposes on a limited amount of its future production and does not use them for trading purposes. Such derivatives are accounted for under Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133) as amended. See Note 6.

Income Tax

The Company follows the asset and liability method of accounting for deferred income taxes prescribed by Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" (SFAS 109). The statement provides for the recognition of a deferred tax asset for deductible temporary timing differences, capital and operating loss carryforwards, statutory depletion carryforward and tax credit carryforwards, net of a valuation allowance. The valuation allowance is provided for that portion of the asset for which it is deemed more likely than not will not be realized. See Note 3.

Accounts Receivable

Accounts receivable consists primarily of accrued oil and gas production receivables. The balance in the reserve for doubtful accounts included in accounts receivable was \$66,000 and \$103,000 at December 31, 2005 and 2004, respectively. Net charge offs recorded against the reserve for doubtful accounts were \$37,000 in 2005 and zero in 2004. There were no provisions to expense in the three-year period ended December 31, 2005.

Table of Contents**Accrued Liabilities to be Refinanced**

Amounts included in accrued liabilities to be refinanced represent capital expenditures that were refinanced with the availability under the Company's senior secured credit facility subsequent to the end of the year.

Major Customers

The Company's production is sold generally on month-to-month contracts at prevailing prices. The following table identifies customers to whom it sold a significant percentage of its total oil and gas production during each of the years ended:

	December 31,		
	2005	2004	2003
Shell Trading Company	34%	30%	
Louis Dreyfus Energy Services	16%	23%	27%
Plains Marketing, L.P.	16%	13%	
Chevron Texaco Natural Gas	10%	6%	
Reliant Energy Services		6%	28%
Prior Energy Corporation			20%

Because alternative purchasers of oil and gas are readily available, the Company believes that the loss of any of these purchasers would not result in a material adverse effect on its ability to market future oil and gas production.

Statements of Cash Flows

For purposes of the Consolidated Financial Statements, the Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

The Company paid no federal income taxes for the three years in the period ended December 31, 2005. During the years ended December 31, 2005, 2004 and 2003, the Company made cash payments for interest of \$19,854,000, \$23,197,000 and \$27,913,000, respectively.

Accounting Pronouncements

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which is a revision of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123). SFAS 123R supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees , and amends Statement of Financial Accounting Standards No. 95, Statement of Cash Flows. Generally, the approach in SFAS 123R is similar to the approach described in SFAS 123. However, SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

In April 2005, the Securities and Exchange Commission (SEC) delayed the effective date of SFAS 123R for public companies to no later than the beginning of the first fiscal year beginning after June 15, 2005. Early adoption is permitted in periods in which financial statements have not yet been issued. SFAS 123R permits public companies to adopt its requirements using one of two methods below:

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A modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123R for all share-based payments granted after the effective date and (b) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123R that remain unvested on the effective date; or

A modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

As permitted by SFAS 123, through December 31, 2005, the Company accounted for share-based payments to employees using APB Opinion 25's intrinsic value method and, as such, generally recognized no compensation cost for employee stock options. Accordingly, the adoption of SFAS 123R's fair value method could have a significant impact on our result of operations, although it will have no impact on our overall financial position. The impact of SFAS 123R cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had we adopted SFAS 123R in prior periods, the impact of that standard would have approximated the impact of SFAS 123 as described in the disclosure of pro forma net income and earnings per share below under Stock-Based Compensation. The Company adopted SFAS 123R on January 1, 2006 using the modified prospective method.

Stock-Based Compensation

The Company's pro forma net income (loss) and net income (loss) per share of common stock for the years ended December 31, 2005, 2004 and 2003 had compensation costs been recorded using the fair value method in accordance with SFAS 123, as amended by Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure-an amendment of SFAS No. 123 (SFAS 148), are presented below pursuant to the disclosure requirements of SFAS 148 (in thousands except per share data):

	2005	2004	2003
	(In thousands, except per share data)		
Net income (loss) available to common shares, as reported	\$ 26,458	\$ 20,229	\$ (19,268)
Stock-based compensation expense included in net income as reported, net of tax	1,313	348	17
Deduct: Total stock-based compensation expense under fair value based method, net of tax	(1,497)	(549)	(247)
Pro forma net income (loss) available to common shares	\$ 26,274	\$ 20,028	\$ (19,498)
Basic earnings (loss) per share: As Reported	1.43	1.28	(1.41)
Pro Forma	1.42	1.27	(1.43)
Diluted earnings (loss) per share: As Reported	1.28	1.22	(1.41)
Pro Forma	1.27	1.20	(1.43)

See Note 11 for descriptions and additional disclosures related to the stock incentive plans.

Table of Contents**Per Share Amounts**

Basic income or loss per common share was computed by dividing net income or loss by the weighted average number of shares of common stock outstanding during the year. Diluted income or loss per common share was determined on a weighted average basis using common shares issued and outstanding adjusted for the effect of stock options considered common stock equivalents computed using the treasury stock method and the effect of the convertible preferred stock (if dilutive). The conversion of the preferred stock was not included in the annual calculation for 2003 due to its antidilutive effect on diluted income or loss per common share. In addition, below are the shares relating to stock options, warrants and restricted stock that were not included in diluted shares for the year ended December 31, 2003 due to the fact that the Company had a loss for this period. The Company had net income for the years ended December 31, 2005 and 2004 and all such shares were included as described below.

	Twelve Months Ended December 31, (in thousands) 2003		
Stock options			63
Warrants			424
Restricted Stock			248
A reconciliation of the basic and diluted per share computation is as follows (in thousands, except per share amounts):			
	2005	2004	2003
(a) Net income (loss) available to common shares	\$ 26,458	\$ 20,229	\$ (19,268)
Preferred dividends assuming conversion of preferred stock(if dilutive)	318	1,272	
(b) Income (loss) available to common shares assuming conversion of preferred stock (if dilutive)	\$ 26,776	\$ 21,501	\$ (19,268)
(c) Weighted average shares outstanding	18,453	15,796	13,662
Dilutive impact of stock options	348	233	
Dilutive impact of restricted stock	69	75	
Dilutive impact of warrants	1,375	894	
Convertible preferred stock (if dilutive)	638	680	
(d) Total diluted shares	20,883	17,678	13,662
Stock options and warrants excluded due to the exercise price being greater than the stock price	1	89	2,297
Basic income (loss) per share (a,c)	\$ 1.43	\$ 1.28	\$ (1.41)
Diluted income (loss) per share (b,d)	\$ 1.28	\$ 1.22	\$ (1.41)

Table of Contents**Fair Value of Financial Instruments**

Fair value of cash, cash equivalents, accounts receivable, accounts payable, the capital lease and the senior secured credit facility approximates book value at December 31, 2005 and 2004. Fair value of long-term debt (specifically, the 9.75% Senior Notes) had an estimated fair value of 103% of face value at December 31, 2005.

3. INCOME TAXES

The Company had a net current asset of \$26.8 million and a net long-term liability of \$31.6 million resulting in a net deferred tax liability of \$4.8 million at December 31, 2005. At December 31, 2004, the Company had a net current asset of \$5.7 million and a net long-term asset of \$3.0 million resulting in a net deferred tax asset of \$8.7 million. Below is an analysis of the net deferred tax asset (liability) as of December 31, 2005 and 2004.

	December 31,	
	2005	2004
	(In thousands)	
Deferred Tax Asset:		
Federal net operating loss carryforwards	\$ 58,240	\$ 56,271
Statutory depletion carryforward	4,443	4,124
Alternative minimum tax credit carryforward	547	326
SFAS 143-Asset Retirement Obligations	11,307	11,544
Other	1,389	2,786
Total deferred tax asset	75,926	75,051
Deferred Tax Liability:		
Difference between book and tax basis for property	(80,565)	(66,277)
Other	(224)	(112)
Total deferred tax liability	(80,789)	(66,389)
Net deferred tax asset (liability)	\$ (4,863)	\$ 8,662

If not utilized, the Company's federal net operating loss carryforwards will expire in 2013 through 2020. The Company has significant state net operating loss carryforwards that are not included in the deferred tax asset above, as the Company does not anticipate generating taxable state income in the states in which these loss carryforwards apply. The Company has very limited state taxable income as primarily all of its revenue is generated in federal waters not subject to state income taxes.

SFAS 109 provides for the weighing of positive and negative evidence in determining whether it is more likely than not that a deferred tax asset is recoverable. The Company achieved profitable operations in 2005 and 2004 and had income on an aggregate basis for the three-year period ended December 31, 2005. In addition, we expect 2006 production levels to meet or exceed 2005 levels. As a result, the Company has not provided a valuation allowance as of December 31, 2005.

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The Company incurred losses in 2002 and 2003 and had losses on an aggregate basis for the three-year period ended December 31, 2003. Because of these cumulative losses the Company established a full valuation allowance of \$11.5 million as of December 31, 2003. For the three-year period ended December 31, 2004, the Company had income on an aggregate basis resulting from the Company achieving profitable operations in 2004 due to the Company's first two deepwater projects starting in November 2003 and the refinancing of the Company's highest cost debt. As a result, the Company reversed the valuation allowance, which had a balance of \$7.0 million, as of December 31, 2004.

Below is a reconciliation of the reported amount of income tax expense attributable to continuing operations for the year to the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations.

	Year Ended December 31,		
	2005	2004	2003
Income tax expense (benefit) computed at the statutory federal income tax rate	35%	35%	(35%)
Change in valuation allowance		(84)%	118%
Other	(1%)		4%
Effective income tax rate	34%	(49)%	87%

4. OTHER COMPREHENSIVE INCOME

The Company's other comprehensive income (loss) of \$1.6 million, \$(1.9 million) and \$449,000 for the years ended December 31, 2005, 2004 and 2003 respectively, relates to the change in fair value of its derivatives (other comprehensive income (loss) was net of tax of \$835,000, \$1.0 million and \$242,000 for the years ended December 31, 2005, 2004 and 2003, respectively). See Note 6.

Table of Contents**5. LONG-TERM DEBT**

Long-term debt consisted of the following at:

	December 31,	
	2005	2004
	(In thousands)	
Senior Secured Credit Facility	\$	\$ 5,000
9.75% Senior Notes (due 2010) net of discount	187,941	186,216
Capital Lease	1,135	1,711
Total Long-term Debt	189,076	192,927
Less current portion	263	576
Long-term portion	\$ 188,813	\$ 192,351

Senior Secured Credit Facility. On June 15, 2004, the Company closed on a three-year senior secured credit facility underwritten by Union Bank of California, N.A. (Union Bank) to replace the Company's credit facility with Wachovia Bank, National Association (Wachovia Bank) which was expiring June 30, 2004. The credit facility had an initial borrowing base of \$60 million, which was increased to \$70 million in the second quarter of 2005. The borrowing base is reviewed and redetermined semi-annually and can be increased to a maximum of \$175 million. Borrowings under the credit facility are secured by mortgages covering the Company's five largest fields. The credit facility bears interest at 0.25% above a defined base rate depending on utilization of the borrowing base or, at the option of the Company, LIBOR plus 1.5% to 2.25% based on utilization of the borrowing base. Under the senior secured credit facility, a commitment fee of 0.25% or 0.375% per annum, depending on the amount of the unused portion of the borrowing base, is payable quarterly.

The range of interest rates on the senior secured credit facility was 4.16% to 6.00% for the year ended December 31, 2005. The weighted average interest rate for the debt outstanding under the senior secured credit facility at December 31, 2004 was 4.16%. As of December 31, 2005 there were no borrowings outstanding under the facility; however, Callon had an aggregate of \$7.5 million in outstanding letters of credit issued under the credit facility. These letters of credit secure obligations under the outstanding hedging contracts described in Note 6. The outstanding letters of credit reduce the amount available for borrowings under the credit facility. As a result, \$62.5 million was available for future borrowings under the credit facility as of December 31, 2005.

Certain of the Company's subsidiaries guarantee the Company's obligations under the \$200 million 9.75% Senior Notes due 2010. The subsidiary guarantors are 100% owned, all of the guarantees are full and unconditional and joint and several, the parent company has no independent assets or operations and any subsidiaries of the parent company other than the subsidiary guarantors are minor.

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Restructured Debt. In December 2003 and in the first half of 2004, the Company completed several transactions which restructured all debt that was maturing through 2005. A summary of these transactions is as follows:

borrowing \$185 million pursuant to a senior unsecured credit facility for a term of seven years at an interest rate of 9.75% in December 2003;

the formation of Medusa Spar LLC in which the Company contributed its 15% ownership in the deepwater spar production facilities in return for a 10% interest in Medusa Spar LLC and approximately \$25 million in cash;

borrowing an additional \$15 million for a term of seven years at an interest rate of 9.75% pursuant to a senior unsecured credit agreement in the first quarter of 2004;

closing a three-year senior secured credit facility with an initial borrowing base of \$60 million in June 2004 which can be increased by the lender to \$175 million; and

closing the public offering of 3,450,000 shares of common stock priced at \$13.25 per share raising net proceeds of approximately \$44 million, after expenses, in June 2004.

Below is a list of the debt which was extinguished and restructured with the funds raised from the transactions above. the Company's \$22.9 million, 10.125% senior subordinated notes due in 2004

the Company's \$40 million, 10.25% senior subordinated notes due in 2004

the Company's \$95 million, 12% senior unsecured credit facility due in 2005

the Company's \$33 million, 11% senior subordinated notes due in 2005

All of the above debt was extinguished before maturity which resulted in a loss on early extinguishment of debt for the years ended December 31, 2004 and 2003 of \$3.0 million and \$5.6 million, respectively. In addition to restructuring the Company's debt, Callon reduced the balance outstanding on its senior secured credit facility.

9.75% Senior Notes (due 2010). In December 2003 the Company borrowed \$185 million pursuant to a senior unsecured credit facility. The loans under the credit facility have a stated interest rate of 9.75% and a seven-year maturity. The net proceeds of \$181.3 million were used to redeem \$22.9 million of 10.125% senior subordinated notes due July 31, 2004, \$40 million of 10.25% senior subordinated notes due September 15, 2004 and \$85 million of our 12% senior loans due March 31, 2005 plus a 1% pre-payment premium of \$850,000, and to reduce the balance outstanding under the Company's senior secured credit facility. In conjunction with the new senior unsecured notes, the Company issued detachable warrants to purchase 2.775 million shares of its common stock at an exercise price of \$10 per share and an expiration date of December 2010. The warrants were valued at \$10.6 million and were treated as a discount on the debt. This senior unsecured debt matures December 8, 2010 and has an effective interest rate of 11.4%. The Company recorded the issuance of these new securities at a fair value of \$171 million. Deferred costs of \$14 million associated with the notes will be amortized over the life of the notes.

During March 2004, Callon borrowed an additional \$15 million under its 9.75% senior unsecured credit facility bringing the total outstanding under the facility to \$200 million. The net proceeds of approximately \$14 million were primarily used to retire the remaining \$10 million of 12% senior loans due March 31, 2005 plus a 1% call premium of \$100,000. The Company recorded the issuance of these additional new securities at a fair value of \$14 million. Deferred costs of \$1 million associated with the notes will be amortized over the life of the notes.

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In March 2004, the \$200 million in aggregate principal amount of loans outstanding under the 9.75% senior unsecured credit facility were exchanged for 9.75% Senior Notes due 2010, Series A, Series A notes, issued pursuant to a senior indenture between Callon and American Stock Transfer & Trust Company dated March 15, 2004. On August 12, 2004, the Company completed an offer to exchange its 9.75% Senior Notes due 2010, Series B, that have been registered under the Securities Act of 1933, for all outstanding Series A notes.

In December 2005, 79,500 of the detachable warrants issued with the 9.75% Senior Notes due 2010 were exercised. In addition, 265,210 of \$0.01 warrants associated with the 12% senior unsecured credit facility due in 2005 were outstanding as of December 31, 2005.

Capital Lease. In December 2001, the Company entered into a 10-year gas processing agreement associated with a production facility on Callon's Mobile Block 952 Field with Hanover Compression Limited Partnership, which is being accounted for as a capital lease. Total minimum obligations are \$8.4 million with interest representing approximately \$2.8 million and the present value minimum obligations representing \$5.6 million.

Restrictive Covenants. The Indenture governing our 9.75% senior notes due 2010 and our senior secured credit facility contains various covenants including restrictions on additional indebtedness and payment of cash dividends. In addition, our senior secured credit facility contains covenants for maintenance of certain financial ratios. The Company was in compliance with these covenants at December 31, 2005.

Future minimum lease payments and debt maturities (in thousands) are as follows:

Year	Capital Lease Payments	Debt
2006	\$ 439	\$
2007	348	
2008	228	
2009	229	
2010	220	200,000
Thereafter	245	

Table of Contents**6. DERIVATIVES**

The Company periodically uses derivative financial instruments to manage oil and gas price risk. Settlements of gains and losses on commodity price contracts are generally based upon the difference between the contract price or prices specified in the derivative instrument and a NYMEX price or other cash or futures index price.

The Company's derivative contracts that are accounted for as cash flow hedges under SFAS 133 are recorded at fair market value and the changes in fair value are recorded through other comprehensive income (loss), net of tax, in stockholders' equity. The cash settlements on these contracts are recorded as an increase or decrease in oil and gas sales. The changes in fair value related to ineffective derivative contracts are recognized as derivative expense (income). The cash settlement on these contracts is also recorded within derivative expense (income). The changes in fair value of the Company's derivative contracts that are not designated as effective cash flow hedges are recorded through the statement of operations as derivative expense (income).

Cash settlements on effective cash flow hedges for the years ended December 31, 2005, 2004 and 2003 resulted in a reduction of oil and gas sales in the amount of \$10.3 million, \$13.8 million and \$2.9 million, respectively. Cash settlements on ineffective derivative contracts were recorded as derivative expense in the amount of \$4.4 million and \$1.2 million for the years ended December 31, 2005 and 2004, respectively. These contracts were deemed ineffective as a result of a shortfall in production volumes due to downtime from the tropical storm activity in the third quarters of 2005 and 2004 impacting third and fourth quarter production volumes for the respective years.

The following table summarizes derivative expense for the periods presented (in thousands):

	2005	December 31, 2004	2003
Amortization of derivative contract premiums	\$ 1,634	\$	\$
Change in fair value and settlements of ineffective derivative contracts	4,394	1,209	
Change in fair value and settlements of non-designated derivative contracts		162	535
	\$ 6,028	\$ 1,371	\$ 535

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The Company had a current liability of \$1.2 million and a current asset of \$889,000 relating to the fair value of its respective derivative contracts as of December 31, 2005.

Listed in the table below are the outstanding derivative contracts as of December 31, 2005:

Swaps

Product	Volumes per Month	Quantity Type	Average Price	Period
Oil	15,000	Bbls	\$ 55.00	01/06-06/06

Collars

Product	Volumes per Month	Quantity Type	Average Floor Price	Average Ceiling Price	Period
Oil	30,000	Bbls	\$60.00	\$77.10	01/06-12/06
Natural Gas	200,000	MMBtu	\$ 10.00	\$ 16.00	01/06-03/06
Natural Gas	100,000	MMBtu	\$ 8.33	\$ 11.93	01/06-09/06

7. COMMITMENTS AND CONTINGENCIES

From time to time, the Company, as part of the Consolidation and other capital transactions, entered into registration rights agreements whereby certain parties to the transactions are entitled to require the Company to register common stock of the Company owned by them with the Securities and Exchange Commission for sale to the public in firm commitment public offerings and generally to include shares owned by them, at no cost, in registration statements filed by the Company. Costs of the offering will not include broker's discounts and commissions, which will be paid by the respective sellers of the common stock.

The Company is involved in various claims and lawsuits incidental to its business. In the opinion of management, the ultimate liability thereunder, if any, will not have a material adverse effect on the financial position or results of operations of the Company.

The Company's Medusa deepwater property is eligible for royalty suspensions pursuant to the Deep Water Royalty Relief Act. In addition, the Company has several shallow water, deep natural gas properties and prospects that are eligible for royalty suspensions. However, the federal offshore leases covering these properties contain price threshold provisions for oil and gas prices. Under these price threshold provisions, if the average monthly New York Mercantile Exchange (NYMEX) sales price for oil or gas during a fiscal year exceeds the price threshold for oil or gas, respectively, then royalties on the associated production must be paid to the Minerals Management Service (MMS) at the rate stipulated in the lease. The price thresholds are adjusted annually by the implicit price deflator for the GDP. The determination of whether or not royalties are due as a result of the average NYMEX price exceeding the price threshold is made during the first quarter of the succeeding year. Any royalty payments due must be made shortly after this determination is made. If a royalty payment is due for all production during a year as a result of exceeding the price threshold, the lessee is required to make monthly royalty payments during the succeeding fiscal year for the succeeding year's production. If at the end of any year the average NYMEX price is below the price threshold, the lessee can apply for a refund for any associated royalties paid during that year and the lessee will not be required to pay royalties monthly during the succeeding year for the succeeding year's production.

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The thresholds and actual average NYMEX for 2005 are in the table below.

	2005	
	Threshold	Actual Average NYMEX
Deepwater Oil Prices (\$/bbl)	34.73	56.57
Deepwater Natural Gas Prices (\$/mmbtu)	4.34	8.96
Shallow Water, Deep Natural Gas Prices (\$/mmbtu)	9.60	8.96

The Company was required to make monthly royalty payments for 2005 deepwater oil and gas production and will be required to make monthly royalty payments for 2006. With regard to the shallow water, deep natural gas royalty relief, the Company will not be required to make monthly royalty payments for 2006.

In the year succeeding the year in which any of the Company's properties became subject to royalties as the result of the average NYMEX price exceeding the price threshold, the portion of reserves attributable to potential future royalties would not be included in a year-end reserve report. However, if the average NYMEX prices were below the price thresholds in subsequent years, our reserves would be increased to reflect reserves previously attributed to future royalties. As a result, reported oil and gas reserves could materially increase or decrease, depending on the relation of price thresholds versus the average NYMEX prices. The reduction in revenues resulting from an obligation to pay these royalties and subsequent reduction of proved reserves could have a material adverse effect on the Company's results of operations and financial condition. The Company's reserve report as of December 31, 2005 excluded oil and gas reserves for Medusa that are subject to MMS royalties as a result of the average 2005 NYMEX prices for oil and gas exceeding the price thresholds.

The Company's activities are subject to federal, state and local laws and regulations governing environmental quality and pollution control. Although no assurances can be made, the Company believes that, absent the occurrence of an extraordinary event, compliance with existing federal, state and local laws, rules and regulating the release of materials in the environment or otherwise relating to the protection of the environment will not have a material effect upon the capital expenditures, earnings or the competitive position of the Company with respect to its existing assets and operations. The Company cannot predict what effect additional regulation or legislation, enforcement policies thereunder, and claims for damages to property, employees, other persons and the environment resulting from the Company's operations could have on its activities.

8. ASSET RETIREMENT OBLIGATIONS

As discussed in Note 2, the Company adopted SFAS 143 on January 1, 2003. The impact of adopting the statement resulted in a gain of \$181,000, net of tax, which was reported as a cumulative effect of change in accounting principle. Approximately \$30.3 million was recorded as the present value of asset retirement obligations on January 1, 2003 with the adoption of SFAS 143 related to the Company's oil and gas properties. Interest is accreted on this amount and reported as accretion expense in the Consolidated Statements of Operations.

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Assets, primarily short-term U.S. Government securities, of approximately \$6.0 million at December 31, 2005, of which \$4.1 million was current, was recorded as restricted investments. These assets are held in abandonment trusts (Trusts) dedicated to pay future abandonment costs of oil and gas properties in which the Company has sold a net profit interest (NPI). In September 2005, Callon purchased the NPI s which included the Trusts. See Note 10 to the Consolidated Financial Statements for more detail on the NPI transaction.

The following table summarizes the activity for the Company s asset retirement obligations:

	Twelve Months Ended	
	December 31, 2005	December 31, 2004
Asset retirement obligations at beginning of period	\$ 38,282	\$ 33,691
Accretion expense	3,549	3,400
Net profits interest accretion	331	459
Liabilities incurred	2,365	3,065
Liabilities settled	(5,184)	(2,076)
Revisions to estimate	(1,070)	(257)
Asset retirement obligation at end of period	38,273	38,282
Less: current retirement obligations	(21,660)	(13,300)
Long-term retirement obligations	\$ 16,613	\$ 24,982

Table of Contents**9. OIL AND GAS PROPERTIES**

The following table discloses certain financial data relating to the Company's oil and gas activities, all of which are located in the United States.

	Years Ended December 31,		
	2005	2004	2003
	(In thousands)		
Capitalized costs incurred:			
Evaluated Properties-			
Beginning of period balance	\$ 862,101	\$ 802,912	\$ 762,918
Property acquisition costs	6,627	1,355	1,154
Exploration costs	46,379	26,749	21,390
Development costs	26,481	32,004	33,972
SFAS 143-Asset Retirement Obligation	(3,890)	(918)	18,002
Medusa Spar transaction			(33,542)
Sale of mineral interests		(1)	(982)
End of period balance	\$ 937,698	\$ 862,101	\$ 802,912
Unevaluated Properties (excluded from amortization) -			
Beginning of period balance	\$ 39,042	\$ 34,251	\$ 40,997
Additions	18,739	16,367	5,228
Capitalized interest	5,655	4,577	4,862
Transfers to evaluated	(14,371)	(16,153)	(16,836)
End of period balance	\$ 49,065	\$ 39,042	\$ 34,251
Accumulated depreciation, depletion and amortization-			
Beginning of period balance	\$ 494,453	\$ 447,000	\$ 426,254
Provision charged to expense	44,946	47,453	28,195
Cumulative effect of change in accounting Principle			(7,449)
End of period balance	\$ 539,399	\$ 494,453	\$ 447,000

Unevaluated property costs, primarily lease acquisition costs incurred at federal and state lease sales, unevaluated drilling costs, capitalized interest and general and administrative costs being excluded from the amortizable evaluated property base, consisted of \$18.8 million incurred in 2005, \$7.8 million incurred in 2004 and \$22.5 million incurred in 2003 and prior. These costs are directly related to the acquisition and evaluation of unproved properties and major development projects. The excluded costs and related reserves are included in the amortization base as the properties are evaluated and proved reserves are established or impairment is determined. The Company expects that the majority of these costs will be evaluated over the next three to five-year period.

Depletion per unit-of-production (thousand cubic feet of gas equivalent) amounted to \$2.39, \$2.18 and \$2.03 for the years ended December 31, 2005, 2004, and 2003, respectively.

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Under the full-cost accounting rules of the SEC, the Company reviews the carrying value of its proved oil and gas properties each quarter. Under these rules, capitalized costs of proved oil and gas properties net of accumulated depreciation, depletion and amortization (DD&A) and deferred income taxes, may not exceed the present value of estimated future net cash flows from proved oil and gas reserves, discounted at 10 percent, plus the lower of cost or fair value of unproved properties net of related tax effects. These rules generally require pricing future oil and gas production at the unescalated market price for oil and gas at the end of each fiscal quarter and require a write-down if the ceiling is exceeded, unless prices recover sufficiently subsequent to the balance sheet date before the release of the financial statements. Given the volatility of oil and gas prices, it is reasonably possible that the Company's estimate of discounted future net cash flows from proved oil and gas reserves could change in the near term. If oil and gas prices decline significantly, even if only for a short period of time, it is possible that writedowns of oil and gas properties could occur in the future.

10. NET PROFITS INTEREST

From 1989 through 1994, the Constituent Entities entered into separate agreements to purchase certain oil and gas properties with gross contract acquisition prices of \$170,000,000 (\$150,000,000 net as of closing dates) and in simultaneous transactions, entered into agreements to sell overriding royalty interests (ORRI) in the acquired properties. These ORRI were in the form of NPI's equal to a significant percentage of the excess of gross proceeds over costs, as defined by the agreements, from the acquired oil and gas properties. In September 2005, the Company purchased the NPI's for \$5 million before intervening operations. Included in the transaction were the Trusts which were established at the inception of the NPI's for future plugging and abandonment liabilities.

The Company, pursuant to the purchase agreements, created the Trusts (see Note 8) whereby funds are provided out of gross production proceeds from the properties for the estimated amount of future abandonment obligations related to the working interests owned by the Company. The Trusts are administered by unrelated third party trustees for the benefit of the Company's working interest in each property. The Trust agreements limit disbursement of funds to the satisfaction of abandonment obligations. Any funds remaining in the Trusts after all restoration, dismantlement and abandonment obligations have been met will be distributed to Callon. Estimated future revenues and costs associated with the Trusts are also excluded from the oil and gas reserve disclosures at Note 13. As of December 31, 2005 and 2004, the Trusts' assets (all cash and investments) totaled \$6.0 million and \$7.7 million respectively, all of which will be available to the Company to pay the restoration, dismantlement and abandonment costs. SFAS 143, discussed in Note 2 and 8, does not allow the Trusts' assets to be used to offset the associated abandonment liability. The Company did not record any income or loss associated with the Trust asset or abandonment liability as a result of adoption of SFAS 143.

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11. EMPLOYEE BENEFIT PLANS

The Company has adopted a series of incentive compensation plans designed to align the interest of the executives and employees with those of its stockholders. The following is a brief description of each plan:

Savings and Protection Plan

The Savings and Protection Plan (401-K Plan) provides employees with the option to defer receipt of a portion of their compensation and the Company may, at its discretion, match a portion of the employee s deferral with cash and Company Common Stock. The Company may also elect, at its discretion, to contribute a non-matching amount in cash and Company Common Stock to employees. The amounts held under the 401-K Plan are invested in various funds maintained by a third party in accordance with the directions of each employee. An employee is fully vested, including Company discretionary contributions, immediately upon participation in the 401-K Plan. The total amounts contributed by the Company, including the value of the common stock contributed, were \$557,000, \$528,000 and \$562,000 in the years 2005, 2004 and 2003, respectively.

1994 Stock Incentive Plan

The 1994 Stock Incentive Plan (the 1994 Plan), approved by the shareholders in 1994, provides for 600,000 shares of Common Stock to be reserved for issuance pursuant to such plan. Under the 1994 Plan, the Company may grant both stock options qualifying under Section 422 of the Internal Revenue Code and options that are not qualified as incentive stock options, as well as performance shares. These options have an expiration date of 10 years from the date of grant.

1996 Stock Incentive Plan

On August 23, 1996, the Board of Directors of the Company approved and adopted the Callon Petroleum Company 1996 Stock Incentive Plan (the 1996 Plan). The 1996 Plan was approved by the shareholders in 1997 and provides for the same types of awards as the 1994 Plan and is limited to a maximum of 1,200,000 shares (as amended from the original 900,000 shares) of common stock that may be subject to outstanding awards. Unvested options are subject to forfeiture upon certain termination of employment events and expire 10 years from the date of grant.

The Company granted 533,000 stock options to employees on March 23, 2000 and 120,000 stock options to directors on July 25, 2000 at \$10.50 per share. The March 23, 2000 grant was subject to shareholder approval of an amendment to the 1996 Stock Incentive Plan. The amendment, which was approved on May 9, 2000 at the Annual Meeting of Shareholders, increased the number of shares reserved for issuance under the 1996 plan to 2,200,000 shares. The excess of the market price over the exercise price on the approval date of the amendment was amortized over the three-year vesting period of the options. Compensation costs of \$27,000 were recognized in 2003, related to these options.

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In 2004, the Company awarded 455,000 performance shares from the 1994 and 1996 Plans. These shares vest to the recipients over a five-year period (one-fifth in each year) beginning in July 2005. The deferred compensation portion of this grant will be amortized to expense over the vesting period. The non-cash amortization expense in 2005 and 2004 was \$1,029,000 and \$532,000, respectively. In 2005, an additional non-cash expense of \$989,000 was recognized for accelerated vesting of performance shares for an executive officer and two directors of the Company, two of whom are deceased, and the retirement of an employee.

2002 Stock Incentive Plan

On February 14, 2002, the Board of Directors of the Company approved and adopted the 2002 Stock Incentive Plan (the 2002 Plan). Pursuant to the 2002 Plan, 350,000 shares of common stock shall be reserved for issuance upon the exercise of options or for grants of stock options, stock appreciation rights or units, bonus stock, or performance shares or units. This Plan qualified as a broadly based plan under the provisions of the New York Stock Exchange s rules and regulations and therefore did not require shareholder approval. Because the 2002 Plan is a broadly based plan, the aggregate number of shares underlying awards granted to officers and directors cannot exceed 50% of the total number of shares underlying the awards granted to all employees during any three-year period.

In 2002, the Company awarded 300,000 shares of restricted stock from the 1996 and the 2002 Plan and 70,500 from treasury shares to be issued as vested. The issuance of the restricted stock using treasury shares did not require shareholder approval pursuant to the New York Stock Exchange s rules and regulations, and therefore shareholder approval was not sought. These shares vested to the recipients over a three-year period (one-third in each year) beginning in November 2002. The deferred compensation portion of this grant was amortized to expense over the vesting period. The non-cash amortization expense in 2004 and 2003 was \$374,000 and \$454,000, respectively.

Employee Stock Purchase Plan

In 1997, the Board of Directors authorized the implementation of the Callon Petroleum Company 1997 Employee Stock Purchase Plan (the 1997 ESPP), which was approved by the Company s shareholders at the 1997 Annual Meeting. The 1997 ESPP provided eligible employees of the Company with the opportunity to acquire a proprietary interest in the Company through participation in a payroll deduction-based employee stock purchase plan. An aggregate of 250,000 shares of common stock were reserved for issuance over the 10-year term of the 1997 ESPP. The purchase price per share at which common stock was purchased on the participant s behalf on each purchase date within an offering period was equal to 85 percent of the fair market value per share of common stock. As of December 31, 2004 there were no remaining shares available for purchase.

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A summary of the status of the Company's stock option plans for the three most recent years and changes during the years then ended is presented in the table and narrative below:

	2005		2004		2003	
	Shares	Wtd Avg Ex Price	Shares	Wtd Avg Ex Price	Shares	Wtd Avg Ex Price
Outstanding, beginning of year	1,512,599	\$ 9.93	2,450,867	\$ 9.84	2,520,417	\$ 9.90
Granted (at market)	65,000	15.79	25,000	12.40	30,000	5.12
Exercised	(329,441)	10.34	(437,918)	9.74	(500)	4.10
Forfeited			(525,350)	9.80	(99,050)	9.74
Expired	(42,600)	10.60				
Outstanding, end of year	1,205,558	\$ 10.11	1,512,599	\$ 9.93	2,450,867	\$ 9.84
Exercisable, end of year	1,166,558	\$ 9.88	1,446,486	\$ 10.20	2,262,067	\$ 10.31
Weighted average fair value of options granted (at market)	\$ 5.93		\$ 4.48		\$ 2.97	

The following table sets forth additional information regarding options outstanding at December 31, 2005. Contractual life and exercise prices represent weighted averages for options outstanding and options exercisable.

Range of exercise prices	Options Outstanding			Options Exercisable	
	Number	Contractual Life	Exercise Price	Number	Exercise Price
\$3.70 to \$6.41	185,308	6.6	\$ 4.48	185,308	\$ 4.48
\$9.00 to \$12.40	905,250	3.1	\$10.64	905,250	\$10.64
\$13.56 to \$19.72	115,000	6.4	\$15.67	76,000	\$14.11

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions used for options granted during the years presented are as follows:

	2005	2004	2003
Risk free interest rate	4.3%	3.7%	4.0%
Expected life (years)	4.5	5.0	5.0
Expected volatility	37.5%	45.1%	65.3%
Expected dividends			

Table of Contents**12. EQUITY TRANSACTIONS**

On June 13, 2005, Callon called for redemption all of the Company's outstanding shares of \$2.125 Convertible Exchange Preferred Stock, Series A. A notice of redemption and letter of transmittal was mailed to all holders of record as of the close of business on June 10, 2005. Between June 13, 2005 and June 30, 2005, 180,173 shares of preferred stock were converted into 409,496 shares of the Company's common stock. Subsequent to June 30, 2005, 392,935 shares of preferred stock were converted into 893,076 shares of the Company's common stock. In addition, 23,563 shares of the Company's preferred stock were redeemed for \$606,000 on July 14, 2005. As a result of the redemption, we will benefit from an annual cash savings of \$1.3 million in dividend payments.

On June 22, 2004, we closed the public offering of three million shares of common stock priced at \$13.25 per share raising net proceeds of approximately \$38.2 million, after expenses. In addition, we granted the underwriter, Johnson Rice & Company L.L.C., an over-allotment option to purchase an additional 450,000 shares. On June 30, 2004, the underwriter exercised the over-allotment option for an additional 450,000 shares priced at \$13.25 per share, raising the net proceeds of the offering by approximately \$5.7 million, after expenses. The proceeds from the transactions were used to redeem \$33 million of the 11% Senior Subordinated Notes due December 15, 2005 and for general corporate purposes.

The Company adopted a stockholder rights plan on March 30, 2000, designed to assure that the Company's stockholders receive fair and equal treatment in the event of any proposed takeover of the Company and to guard against partial tender offers, squeeze-outs, open market accumulations, and other abusive tactics to gain control without paying all stockholders a fair price. The rights plan was not adopted in response to any specific takeover proposal. Under the rights plan, the Company declared a dividend of one right (Right) on each share of the Company's Common Stock. Each Right will entitle the holder to purchase one one-thousandth of a share of a Series B Preferred Stock, par value \$0.01 per share, at an exercise price of \$90 per one one-thousandth of a share.

The Rights are not currently exercisable and will become exercisable only in the event a person or group acquires, or engages in a tender or exchange offer to acquire, beneficial ownership of 15 percent or more (one existing stockholder was granted an exception for up to 21 percent) of the Company's Common Stock. After the Rights become exercisable, each Right will also entitle its holder to purchase a number of common shares of the Company having a market value of twice the exercise price. The dividend distribution was made to stockholders of record at the close of business on April 10, 2000. The Rights will expire on March 30, 2010.

13. SUPPLEMENTAL OIL AND GAS RESERVE DATA (UNAUDITED)

The Company's proved oil and gas reserves at December 31, 2005, 2004 and 2003 have been estimated by Huddleston & Co., Inc. who are the Company's independent petroleum consultants. The reserves were prepared in accordance with guidelines established by the Securities and Exchange Commission (SEC). Accordingly, the following reserve estimates are based upon existing economic and operating conditions.

There are numerous uncertainties inherent in establishing quantities of proved reserves. The following reserve data represents estimates only and should not be construed as being exact. In addition, the standardized measure of discounted future net cash flows should not be construed as the current market value of the Company's oil and gas properties or the cost that would be incurred to obtain equivalent reserves. See Note 7 regarding the Deep Water Royalty Relief Act and the loss of reserves.

Table of Contents**Estimated Reserves**

Changes in the estimated net quantities of crude oil and natural gas reserves, all of which are located onshore and offshore in the continental United States, are as follows:

Reserve Quantities

	Years Ended December 31,		
	2005	2004	2003
Proved developed and undeveloped reserves:			
Crude Oil (MBbls):			
Beginning of period	19,748	23,709	24,043
Revisions to previous estimates	316	(2,370)(a)	(1)
Purchase of reserves in place	71		
Sales of reserves in place			(65)
Extensions and discoveries	129	145	
Production	(1,836)	(1,736)	(268)
End of period	18,428	19,748	23,709
Natural Gas (MMcf):			
Beginning of period	72,619	74,691	91,539
Revisions to previous estimates	(4,946)	2,138	(6,407)(a)
Purchase of reserves in place	1,308		
Sales of reserves in place			(49)
Extensions and discoveries	16,808	7,177	1,923
Production	(7,768)	(11,387)	(12,315)
End of period	78,021	72,619	74,691
Proved developed reserves:			
Crude Oil (MBbls):			
Beginning of period	10,292	9,919	1,056
End of period	7,323	10,292	9,919
Natural Gas (MMcf):			
Beginning of period	33,982	31,415	37,631
End of period	30,982	33,982	31,415

(a) Includes
Medusa royalty
adjustment

Table of Contents**Standardized Measure**

The following tables present the Company's standardized measure of discounted future net cash flows and changes therein relating to proved oil and gas reserves and were computed using reserve valuations based on regulations prescribed by the SEC. These regulations provide that the oil, condensate and gas price structure utilized to project future net cash flows reflects current prices (approximately \$10.13 per Mcf for natural gas and \$55.44 per Bbl for oil for the 2005 disclosures, \$6.51 per Mcf and \$36.72 per Bbl for 2004 disclosures, and \$5.99 per Mcf and \$30.50 per Bbl for 2003 disclosures) at each date presented and have not been escalated. Future production and development costs are based on current costs without escalation. The resulting net future cash flows have been discounted to their present values based on a 10% annual discount factor.

Standardized Measure

	Years Ended December 31,		
	2005	2004	2003
	(In thousands)		
Future cash inflows	\$ 1,814,208	\$ 1,198,096	\$ 1,170,118
Future costs			
Production	(238,321)	(231,616)	(219,421)
Development and net abandonment	(88,070)	(74,335)	(111,850)
Future net inflows before income taxes	1,487,817	892,145	838,847
Future income taxes	(379,287)	(166,284)	(89,567)
Future net cash flows	1,108,530	725,861	749,280
10% discount factor	(270,978)	(209,968)	(230,254)
Standardized measure of discounted future net cash flows	\$ 837,552	\$ 515,893	\$ 519,026

Changes in Standardized Measure

	Years Ended December 31,		
	2005	2004	2003
	(In thousands)		
Standardized measure beginning of period	\$ 515,893	\$ 519,026	\$ 556,046
Sales and transfers, net of production costs	(116,913)	(97,494)	(62,396)
Net change in sales and transfer prices, net of production costs	391,570	86,551	(41,011)
Exchange and sale of in place reserves			(1,226)
Purchases, extensions, discoveries, and improved recovery, net of future production and development costs incurred	127,848	77,576	25,632
Revisions of quantity estimates	(17,241)	(41,314)	(18,018)
Accretion of discount	61,259	57,046	62,394
Net change in income taxes	(154,460)	(45,262)	16,460
Changes in production rates, timing and other	29,596	(40,236)	(18,855)
Standardized measure end of period	\$ 837,552	\$ 515,893	\$ 519,026

Table of Contents**14. SUMMARIZED QUARTERLY FINANCIAL INFORMATION (UNAUDITED)**

2005	First Quarter	Second Quarter	Third Quarter(a)	Fourth Quarter(a)
	(In thousands, except per share data)			
Total revenues	\$43,012	\$41,668	\$31,722	\$24,888
Income from operations	18,134	17,696	8,692	9,783
Net income	9,475	9,311	3,683	4,307
Net income per common share basic	\$ 0.52	\$ 0.52	\$ 0.19	\$ 0.22
Net income per common share diluted	0.46	0.46	0.17	0.20
2004	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(In thousands, except per share data)			
Total revenues	\$31,919	\$37,606	\$25,138	\$25,139
Income from operations	10,231	14,543	5,367	6,371
Net income	2,102	9,730	546	9,123(b)
Net income per common share-basic	\$ 0.13	\$ 0.66	\$ 0.01	\$ 0.50(b)
Net income per common share-diluted	0.12	0.58	0.01	0.45(b)

(a) These quarters were impacted by tropical storm and hurricane activity.

(b) The fourth quarter of 2004 includes a tax benefit of \$6.7 million resulting from the elimination of the valuation allowance established in 2003. See Note 3.

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

There have been no disagreements with the independent auditors on any matters of accounting principles or practices, financial statement disclosure, or auditing scope or procedures.

ITEM 9.A CONTROLS AND PROCEDURES

The term disclosure controls and procedures is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, or the Exchange Act. This term refers to the controls and procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission. Our management, including our Chief Executive Officer, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this annual report. Based upon that evaluation, our Chief Executive Officer has concluded that our disclosure controls and procedures were effective as of the end of the period covered by this annual report. There were no changes to our internal control over financial reporting during our last fiscal quarter that have materially affected, or are reasonable likely to materially affect, our internal control over financial reporting.

Management's Report On Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Under the supervision and with the participation of our management, including our principal executive and financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2005 based on the frame work in the Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in Internal Control-Integrated Framework, our management concluded that our internal control over financial reporting was effective as of December 31, 2005.

Ernst & Young LLP, our independent registered public accounting firm, has issued an attestation report on our management's assessment of the effectiveness of our internal control over financial reporting which is included herein.

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Report of Independent Registered Public Accounting Firm

The Stockholders and Board of Directors

Callon Petroleum Company

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Callon Petroleum Company maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Callon Petroleum Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Callon Petroleum Company maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Trading Commission. Also, in our opinion, Callon Petroleum Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

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We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Callon Petroleum Company as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2005 of Callon Petroleum Company and our report dated March 9, 2006, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

New Orleans, Louisiana
March 9, 2006

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ITEM 9.B OTHER INFORMATION

We have disclosed all information required to be disclosed in a current report on Form 8-K during the fourth quarter of the year ended December 31, 2005 in previously filed reports on Form 8-K.

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PART III.

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

For information concerning Item 10, see the definitive proxy statement of Callon Petroleum Company relating to the Annual Meeting of Stockholders on May 4, 2006 which will be filed with the Securities and Exchange Commission and is incorporated herein by reference.

The Company has adopted a code of ethics that applies to the Company's chief executive officer, chief financial officer and chief accounting officer. The full text of such code of ethics has been posted on the Company's website at www.callon.com, and is available free of charge in print to any shareholder who requests it. Request for copies should be addressed to the Secretary at 200 North Canal Street, Natchez, Mississippi 39120.

ITEM 11. EXECUTIVE COMPENSATION.

For information concerning Item 11, see the definitive proxy statement of Callon Petroleum Company relating to the Annual Meeting of Stockholders on May 4, 2006 which will be filed with the Securities and Exchange Commission and is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

For information concerning the security ownership of certain beneficial owners and management, see the definitive proxy statement of Callon Petroleum Company relating to the Annual Meeting of Stockholders on May 4, 2006 which will be filed with the Securities and Exchange Commission and is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

For information concerning Item 13, see the definitive proxy statement of Callon Petroleum Company relating to the Annual Meeting of Stockholders on May 4, 2006 which will be filed with the Securities and Exchange Commission and is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

For information concerning Item 14, see the definitive proxy statement of Callon Petroleum Company relating to the Annual Meeting of Stockholders on May 4, 2006 which will be filed with the Securities and Exchange Commission and is incorporated herein by reference.

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PART IV.

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) 1. The following is an index to the financial statements and financial statement schedules that are filed as part of this Form 10-K on pages 42 through 70.

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of the Years Ended December 31, 2005 and 2004

Consolidated Statements of Operations for the Three Years in the Period Ended
December 31, 2005

Consolidated Statements of Stockholders' Equity for the Three Years in the Period Ended
December 31, 2005

Consolidated Statements of Cash Flows for the Three Years in the Period Ended
December 31, 2005

Notes to Consolidated Financial Statements

(a) 2. Schedules other than those listed above are omitted because they are not required, not applicable or the required information is included in the financial statements or notes thereto.

(a) 3. Exhibits:

2. Plan of acquisition, reorganization, arrangement, liquidation or succession*

3. Articles of Incorporation and Bylaws

3.1 Certificate of Incorporation of the Company, as amended (incorporated by reference to Exhibit 3.1 of the Company's Annual Report on Form 10-K for the year ended December 31, 2003, File No. 001-14039)

3.2 Bylaws of the Company (incorporated by reference from Exhibit 3.2 of the Company's Registration Statement on Form S-4, filed August 4, 1994, Reg. No. 33-82408)

3.3 Certificate of Amendment to Certificate of Incorporation of the Company (incorporated by reference to Exhibit 3.3 of the Company's Annual Report on Form 10-K for the year ended December 31, 2003, File No. 001-14039)

4. Instruments defining the rights of security holders, including indentures

4.1 Specimen Common Stock Certificate (incorporated by reference from Exhibit 4.1 of the Company's Registration Statement on Form S-4, filed August 4, 1994, Reg. No. 33-82408)

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- 4.2 Rights Agreement between Callon Petroleum Company and American Stock Transfer & Trust Company, Rights Agent, dated March 30, 2000 (incorporated by reference from Exhibit 99.1 of the Company's Registration Statement on Form 8-A, filed April 6, 2000, File No. 001-14039)
- 4.3 Warrant dated as of June 29, 2001 entitling Duke Capital Partners, LLC to purchase common stock from the Company. (incorporated by reference to Exhibit 4.11 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2001, File No. 001-14039)
- 4.4 Form of Warrants dated December 8, 2003 and December 29, 2003 entitling lenders under the Company's \$185 million amended and restated senior unsecured credit agreement dated December 23, 2003 to purchase common stock from the Company (incorporated by reference to Exhibit 4.14 of the Company's Annual Report on Form 10-K for the year ended December 31, 2003, File No. 001-14039)
- 4.5 Indenture for the Company's 9.75% Senior Notes due 2010, dated March 15, 2004 between Callon Petroleum Company and American Stock Transfer and Trust Company (incorporated by reference to Exhibit 4.16 of the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2004, File No. 001-14039)
- 9. Voting trust agreement
None.
- 10. Material contracts
 - 10.1 Registration Rights Agreement dated September 16, 1994 between the Company and NOCO Enterprises, L. P. (incorporated by reference from Exhibit 10.2 of the Company's Registration Statement on Form 8-B filed October 3, 1994)
 - 10.2 Counterpart to Registration Rights Agreement by and between the Company, Ganger Rolf ASA and Bonheur ASA. (incorporated by reference from Exhibit 10.2 of the Company's Report on Form 10-K for the fiscal year ended December 31, 2000, File No. 001-14039)
 - 10.3 Registration Rights Agreement dated September 16, 1994 between the Company and Callon Stockholders (incorporated by reference from Exhibit 10.3 of the Company's Registration Statement on Form 8-B filed October 3, 1994)
 - 10.4 Callon Petroleum Company 1994 Stock Incentive Plan (incorporated by reference from Exhibit 10.5 of the Company's Registration Statement on Form 8-B filed October 3, 1994)
 - 10.5 Callon Petroleum Company 1996 Stock Incentive Plan as amended on May 9, 2000 (incorporated by reference from Appendix I of the Company's Definitive Proxy Statement of Schedule 14A filed March 28, 2000)

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- 10.6 Conveyance of Overriding Royalty Interest from the Company to Duke Capital Partners, LLC, dated June 29, 2001 (incorporated by reference to Exhibit 10.03 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2001, File No. 001-14039)
- 10.7 Callon Petroleum Company 2002 Stock Incentive Plan (incorporated by reference to Exhibit 10.13 of the Company's Annual Report on Form 10-K for the year ended December 31, 2001, File No. 001-14039)
- 10.8 Change of Control Severance Compensation Agreement by and between Callon Petroleum Company and Fred L. Callon, dated January 1, 2002 (incorporated by reference to Exhibit 10.15 of the Company's Annual Report on Form 10-K for the year ended December 31, 2001, File No. 001-14039)
- 10.9 Medusa Spar Agreement dated as of August 8, 2003, among Callon Petroleum Operating Company, Murphy Exploration & Production Company-USA and Oceaneering International, Inc. (incorporated by reference to Exhibit 10.19 of the Company's Annual Report on Form 10-K for the year ended December 31, 2003, File No. 001-14039)
- 10.10 Credit Agreement dated as of December 18, 2003 among Medusa Spar LLC, The Bank of Nova Scotia, as Administrative Agent, Bank One, N.A., Sun Trust Bank, as Syndication Agents and other Lenders Party. (incorporated by reference to Exhibit 10.20 of the Company's Annual Report on Form 10-K for the year ended December 31, 2003, File No. 001-14039)
- 10.11 Credit Agreement dated as of June 14, 2004 between the Company and Union Bank of California, N.A., as Administrative Agent (incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K dated June 14, 2004, File No. 001-14039)
- 10.12 Change of Control Severance Compensation Agreement by and between Callon Petroleum and John S. Weatherly dated January 1, 2002 (incorporated by reference to Exhibit 10.14 of the Company's Annual Report on Form 10-K for the year ended December 31, 2001, File No. 001-14039)
- 11. Statement re computation of per share earnings*
- 12. Statements re computation of ratios*
- 13. Annual Report to security holders, Form 10-Q or quarterly reports*
- 14. Code of Ethics
 - 14.1 Code of Ethics for Chief Executive Officers and Senior Financial Officers (incorporated by reference to Exhibit 14.1 of the Company's Annual Report on Form 10-K for the year ended December 31, 2003, File No. 001-14039)
- 16. Letter re change in certifying accountant*

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18.	Letter re change in accounting principles*
21.	Subsidiaries of the Company
21.1	Subsidiaries of the Company (incorporated by reference from Exhibit 21.1 of the Company's Registration Statement on Form 8-B filed October 3, 1994)
22.	Published report regarding matters submitted to vote of security holders*
23.	Consents of experts and counsel
23.1	Consent of Ernst & Young LLP
23.2	Consent of Huddleston & Co., Inc.
24.	Power of attorney*
31.	Rule 13a-14(a) Certifications
31.1	Certification of Chief Executive Officer pursuant to Rule 13(a)-14(a)
32.	Section 1350 Certifications
32.1	Certification of Chief Executive Officer pursuant to Rule 13(a)-14(b)
99.	Additional Exhibits*

*Inapplicable to this filing.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

CALLON PETROLEUM COMPANY

Date: March 15, 2006

/s/ Fred L. Callon

Fred L. Callon (principal executive officer,
principal financial officer and director)

Date: March 15, 2006

/s/ Rodger W. Smith

Rodger W. Smith (principal accounting officer)

Date: March 15, 2006

/s/ Richard Flury

Richard Flury (director)

Date: March 15, 2006

/s/ John C. Wallace

John C. Wallace (director)

Date: March 15, 2006

/s/ B. F. Weatherly

B. F. Weatherly (director)

Date: March 15, 2006

/s/ Richard O. Wilson

Richard O. Wilson (director)

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Pursuant to the requirements of Section 13 or 15(d) 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.

CALLON PETROLEUM COMPANY

Date: March 15, 2006

By: /s/ Fred L. Callon

Fred L. Callon, President and Chief
Executive Officer

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