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CARBON ENERGY CORP
Form 10-Q
May 15, 2001

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

FORM 10-Q

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

For the quarterly period ended March 31, 2001

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: 1-15639

CARBON ENERGY CORPORATION

(Exact name of registrant as specified in its charter)

Colorado

84-1515097

(State or other jurisdiction of
incorporation or organization)

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

1700 Broadway, Suite 1150, Denver, CO

80290

(Address of principal executive offices)

(Zip Code)

(303) 863-1555

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year,
if changed since last report)

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

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

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| | |
|----------------------------|-----------------------------|
| Class | Outstanding at May 14, 2001 |
| ----- | ----- |
| Common stock, no par value | 6,088,592 shares |

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CARBON ENERGY CORPORATION
CONSOLIDATED BALANCE SHEETS
(unaudited)

MARCH 31,
2001

ASSETS

Current assets:

| | |
|-----------------------------------|-----------|
| Cash | \$ - |
| Current portion of employee trust | 632,000 |
| Accounts receivable, trade | 7,076,000 |
| Accounts receivable, other | 572,000 |
| Amounts due from broker | 2,463,000 |
| Prepaid expenses and other | 369,000 |
| | ----- |

| | |
|----------------------|------------|
| Total current assets | 11,112,000 |
| | ----- |

Property and equipment, at cost:

| | |
|---|------------|
| Oil and gas properties, using the full cost method of accounting: | |
| Unproved properties | 6,830,000 |
| Proved properties | 46,740,000 |
| Furniture and equipment | 435,000 |
| | ----- |

54,005,000

| | |
|---|-------------|
| Less accumulated depreciation, depletion and amortization | (7,446,000) |
| | ----- |

| | |
|-----------------------------|------------|
| Property and equipment, net | 46,559,000 |
| | ----- |

| | |
|---------------------------|---------|
| Deposits and other assets | 364,000 |
| | ----- |

| | |
|--------------|---------------|
| Total assets | \$ 58,035,000 |
| | ===== |

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

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MARCH 31,
2001

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:

| | |
|---------------------------------------|--------------|
| Accounts payable and accrued expenses | \$ 7,103,000 |
| Accrued production taxes payable | 532,000 |
| Income taxes payable | 681,000 |
| Undistributed revenue | 1,967,000 |
| Derivative liability | 3,954,000 |

| | |
|---------------------------|------------|
| Total current liabilities | 14,237,000 |
|---------------------------|------------|

| | |
|----------------|------------|
| Long-term debt | 10,432,000 |
|----------------|------------|

| | |
|-----------------------|-----------|
| Deferred income taxes | 1,928,000 |
|-----------------------|-----------|

| | |
|-------------------|--------|
| Minority interest | 24,000 |
|-------------------|--------|

Stockholders' equity:

| | |
|---|-------------|
| Preferred stock, no par value: | |
| 10,000,000 shares authorized, none outstanding | - |
| Common stock, no par value: | |
| 20,000,000 shares authorized, issued, and | |
| 6,033,917 shares and 6,021,626 shares outstanding | |
| at March 31, 2001 and December 31, 2000, respectively | 31,561,000 |
| Retained earnings | 1,981,000 |
| Accumulated other comprehensive income | (2,128,000) |

| | |
|----------------------------|------------|
| Total stockholders' equity | 31,414,000 |
|----------------------------|------------|

| | |
|--|---------------|
| Total liabilities and stockholders' equity | \$ 58,035,000 |
|--|---------------|

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

CARBON ENERGY CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

THREE MONTHS ENDED
MARCH 31,

| | |
|------|------|
| 2001 | 2000 |
|------|------|

Revenues:

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| | | |
|---|--------------|--------|
| Oil and gas sales | \$ 8,794,000 | \$ 3,1 |
| Marketing and other, net | 687,000 | |
| | ----- | ----- |
| | 9,481,000 | 3,2 |
| Expenses: | | |
| Oil and gas production costs | 2,546,000 | 1,0 |
| Depreciation, depletion and amortization expense | 1,388,000 | 1,1 |
| General and administrative expense, net | 1,096,000 | 5 |
| Interest expense, net | 186,000 | 1 |
| | ----- | ----- |
| Total operating expenses | 5,216,000 | 2,9 |
| Minority interest | 22,000 | |
| | ----- | ----- |
| Income before income taxes | 4,243,000 | 3 |
| Income taxes: | | |
| Current | 719,000 | |
| Deferred | 998,000 | |
| | ----- | ----- |
| Total taxes | 1,717,000 | |
| | ----- | ----- |
| Net income before cumulative effect of accounting change | 2,526,000 | 2 |
| Cumulative effect of accounting change, net of tax | (1,510,000) | |
| | ----- | ----- |
| Net income | \$ 1,016,000 | \$ 2 |
| | ===== | ===== |
| Earnings per share: | | |
| Basic | \$ 0.17 | \$ |
| Diluted | 0.16 | |
| Average number of common shares outstanding (in thousands): | | |
| Basic | 6,026 | |
| Diluted | 6,246 | |

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

CARBON ENERGY CORPORATION
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
FOR THE THREE MONTHS ENDED MARCH 31, 2001
(unaudited)

COMMON STOCK

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| | SHARES | AMOUNT | RETAINED EARNINGS |
|---|-----------|---------------|----------------------|
| Balances, December 31, 2000 | 6,021,626 | \$ 31,495,000 | \$ 965,000 |
| Comprehensive income: | | | |
| Net income before cumulative effect of accounting change | - | - | 2,526,000 |
| Cumulative effect of accounting change, net of tax | - | - | (1,510,000) |
| Currency translation adjustment | - | - | - |
| Reclassification adjustment for settled contracts | - | - | - |
| Changes in fair value of outstanding hedging positions | - | - | - |
| Total comprehensive income | | | |
| Common stock issued | 6,666 | 36,000 | - |
| Vesting of restricted stock grants | 5,625 | 30,000 | - |
| Balances, March 31, 2001 | 6,033,917 | \$ 31,561,000 | \$ 1,981,000 |

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

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CARBON ENERGY CORPORATION
CONSOLIDATED STATEMENT OF CASH FLOWS
(unaudited)

| | THREE MONTHS ENDED MARCH 31, | |
|--|---------------------------------|----|
| | 2001 | |
| Cash flows from operating activities: | | |
| Net income before cumulative effect of accounting change | \$ 2,526,000 | \$ |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation, depletion and amortization expense | 1,388,000 | |
| Deferred income tax | 998,000 | |
| Minority interest | 22,000 | |
| Employee stock grants | 30,000 | |
| Changes in operating assets and liabilities net of | | |

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| | |
|---|--------------|
| effects of acquisition: | |
| Decrease (increase) in: | |
| Accounts receivable | (1,222,000) |
| Amounts due from broker | 1,408,000 |
| Employee trust | 51,000 |
| Prepaid expenses and other | 330,000 |
| Increase (decrease) in: | |
| Accounts payable and accrued expenses | (1,674,000) |
| Undistributed revenue | 465,000 |
| | ----- |
| Net cash provided by (used in) operating activities | 4,322,000 |
| Cash flows from investing activities: | |
| Capital expenditures for oil and gas properties | (6,335,000) |
| Cash received from San Juan property sale | 6,758,000 |
| Acquisition of CEC Resources | - |
| Capital expenditures for support equipment | (24,000) |
| | ----- |
| Net cash provided by (used in) investing activities | 399,000 |
| Cash flows from financing activities: | |
| Proceeds from note payable | 19,227,000 |
| Principal payments on note payable | (23,745,000) |
| Proceeds from issuance of common stock | 36,000 |
| CEC share repurchase | (203,000) |
| | ----- |
| Net cash provided by (used in) financing activities | (4,685,000) |
| | ----- |
| Effect of exchange rate changes on cash | (57,000) |
| | ----- |
| Net decrease in cash | (21,000) |
| Cash, beginning of period | 21,000 |
| | ----- |
| Cash, end of period | \$ - |
| | ===== |
| Supplemental cash flow information: | |
| Cash paid for interest | \$ 255,000 |
| Cash paid for taxes | 263,000 |

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

CARBON ENERGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1. NATURE OF OPERATIONS:

NATURE OF OPERATION - Carbon Energy Corporation (Carbon) was incorporated in September 1999 under the laws of the State of Colorado to facilitate the acquisition of Bonneville Fuels Corporation (BFC) and subsidiaries. The acquisition of BFC closed on October 29, 1999 and was accounted for as a purchase. In February 2000, Carbon completed an offer to exchange shares of Carbon for shares of CEC Resources, Ltd. (CEC), an Alberta, Canada company. Over 97% of the shareholders of CEC accepted the offer for exchange. This

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acquisition closed on February 17, 2000 and was also accounted for as a purchase. In November 2000, CEC initiated an offer to purchase shares of CEC stock that were not owned by Carbon. The offer was completed in February 2001 with the acquisition of approximately 34,000 of the 39,000 shares of CEC stock that were not owned by Carbon. Carbon currently owns 99.7% of the stock of CEC. Collectively, Carbon, CEC, BFC and its subsidiaries are referred to as the Company. Carbon is an independent oil and gas company, engaged in the exploration, development and production of natural gas and crude oil in the United States and Canada. The Company's core areas in the United States include the Piceance Basin in Colorado, the Uintah Basin in Utah, the Permian Basin in New Mexico and Texas and the Hugoton Basin in Southwest Kansas. The Company's core areas in Canada include the Carbon Field area of Central Alberta and Southeast Saskatchewan.

The unaudited financial statements presented herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). The statements do not include certain information and note disclosures required by generally accepted accounting principles for complete financial statements. The accompanying consolidated financial statements of the Company should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K, for the year ended December 31, 2000, as filed with the SEC. The statements reflect all adjustments which, in the opinion of management, are necessary to fairly present the Company's financial position at March 31, 2001 and the results of operations and cash flows for the periods presented.

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

2. SIGNIFICANT ACCOUNTING PRINCIPLES:

PRINCIPLES OF CONSOLIDATION - The consolidated financial statements include the accounts of Carbon and its subsidiaries all of which are wholly owned, except CEC of which the Company owns approximately 99.7% of the equity. All significant intercompany transactions and balances have been eliminated.

CASH EQUIVALENTS - The Company considers all highly liquid instruments with original maturities of three months or less when purchased to be cash equivalents.

AMOUNTS DUE FROM BROKER - This account generally represents net cash margin deposits held by a brokerage firm for the Company's futures accounts.

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PROPERTY AND EQUIPMENT - The Company follows the full cost method of accounting for its oil and gas properties, whereby all costs incurred in the acquisition, exploration and development of properties (including costs of surrendered and abandoned leaseholds, delay lease rentals, dry holes and direct overhead related to exploration and development activities) are capitalized.

Capitalized costs are accumulated on a country-by-country basis and are depleted using the units of production method based on proved reserves of oil and gas. The Company presently has two cost centers - the United States and Canada. For purposes of the depletion calculation, oil and gas reserves are converted to a common unit of measure on the basis of six thousand cubic feet of gas to one barrel of oil. A reserve is provided for the estimated future

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cost of site restoration, dismantlement and abandonment activities as a component of depletion. Investments in unproved properties are recorded at the lower of cost or fair market value and are not depleted pending the determination of the existence of proved reserves.

Pursuant to full cost accounting rules, capitalized costs less related accumulated depletion and deferred income taxes may not exceed the sum of (1) the present value of future net revenue from estimated production of proved oil and gas reserves using a 10% discount factor and unescalated oil and gas prices and costs as of the end of the period; plus (2) the cost of properties not being amortized, if any; plus (3) the lower of cost or estimated fair value of unproved properties included in the costs being amortized, if any; less (4) related income tax effects. The costs reflected in the accompanying financial statements do not exceed this limitation.

Proceeds from disposal of interests in oil and gas properties are accounted for as adjustments of capitalized costs with no gain or loss recognized, unless such adjustment would significantly alter the rate of depletion.

Buildings, transportation and other equipment are depreciated on the straight-line method with lives ranging from three to seven years.

EMPLOYEE TRUST - The employee trust represents amounts which will be used to satisfy obligations to persons who have been, or will be, terminated as a result of the Company's acquisition of BFC. The current portion of the employee trust is expected to be disbursed or returned to the Company by October 31, 2001.

UNDISTRIBUTED REVENUE - Represents amounts due to other owners of jointly owned oil and gas properties for their share of revenue from the properties.

REVENUE RECOGNITION - The Company follows the sales method of accounting for natural gas revenues. Under this method, revenues are recognized based on actual volumes of gas sold to purchasers. The volumes of gas sold may differ from the volumes to which the Company is entitled based on its interests in the properties, creating gas imbalances. Revenue is deferred and a liability is recorded for those properties where the estimated remaining reserves will not be sufficient to enable the underproduced owner to recoup its entitled share through production.

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The Company records sales and the related cost of sales on gas marketing transactions using the accrual method of accounting (i.e., the transaction is recorded when the commodity is purchased and/or delivered).

The Company's gas marketing contracts are generally month-to-month and provide that the Company will sell gas to end users which is produced from the Company's properties and/or acquired from third parties.

INCOME TAXES - The Company accounts for income taxes under the liability method which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse.

HEDGING TRANSACTIONS - The Company from time to time uses certain financial

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instruments in an attempt to reduce exposure to the market fluctuations in the price of oil and natural gas. The Company's general strategy is to hedge price and location risk of a portion of the Company's production with swap, collar, futures, and floor and ceiling arrangements. The Company generally enters into hedges for delivery into one of several pipelines located near producing regions of the Company. Pursuant to Company guidelines, the Company is to engage in these activities only as a hedging mechanism. The Company has a Risk Management Committee to administer its production hedging program. It is the policy of the Company that the Risk Management Committee approves all production hedging transactions. Gains or losses from financial instruments that qualify for hedge accounting treatment are recognized as an adjustment to sales revenue when the related transactions being hedged are finalized. Gains or losses from financial instruments that do not qualify for hedge accounting treatment are recognized currently as other income or expense. The cash flows from these instruments are included in operating activities in the consolidated statements of cash flows.

In June 1998, the Financial Accounting Standards Board issue SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133 establishes accounting and reporting standards requiring that every derivative instrument (including certain derivative instruments embedded in other contracts) be recorded on the balance sheet as either an asset or liability measured at its fair value. It also requires that changes in the derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. Special accounting for qualifying hedges allows a derivative's gains and losses to offset related results on the hedged item in the income statement, and requires that a company must formally document, designate and assess the effectiveness of transactions that receive hedge accounting treatment. SFAS No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 2000.

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The table below sets forth the financial statement impact to the Company of recording derivative instruments designated as hedges and derivative instruments not designated as hedges upon the adoption of SFAS No. 133 on January 1, 2001.

| | Amount (millions) |
|--|----------------------|
| | |
| Balance Sheet: | |
| Derivative liability | \$ (7.2) |
| Deferred tax asset | 2.9 |
| Cumulative effect of a change in accounting principle (other comprehensive loss) | 2.8 |
| Statement of Operations: | |
| Cumulative effect of a change in accounting liabilities for principle (derivative loss) | \$ 1.5 |

During the first quarter of 2001, net hedging losses of \$1.2 million (\$727,000 after tax) were transferred from other comprehensive income and the change in the fair market value of outstanding derivative liabilities for contracts designated as hedges decreased \$956,000 (\$516,000 after tax). As of March 31, 2001, the Company had net unrealized hedging losses of \$2.5 million

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(\$1.5 million after tax). The Company expects to reclassify these losses to earnings during the next twelve month period.

The table below sets forth BFC's and CEC's derivative financial instrument positions that qualify for hedge accounting treatment on its natural gas production as of March 31, 2001.

Futures and swaps:

| BFC Contracts | | | | CEC Contracts | | |
|---------------|---------|---|--|---------------|---------|---|
| Year | MMBtu | Weighted Average Fixed Price per MMBtu | Derivative Asset/ (Liability) (thousands) | Year | MMBtu | Weighted Average Fixed Price per MMBtu |
| 2001 | 680,000 | \$ 2.17 | \$ (2,068) | 2001 | 275,000 | \$ 2.21 |

Collars:

| CEC Contracts | | | | |
|---------------|--------|-------------------------------|---------------------------------|--|
| Year | MMBtu | Average Floor per MMBtu | Average Ceiling per MMBtu | Derivative Asset/ (Liability) (thousands) |
| 2001 | 203,00 | \$ 4.51 | \$ 5.70 | \$ 4 |

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With the adoption of FAS 133, the Company has a derivative contract that no longer qualifies for hedge accounting treatment. The table below sets forth the position of this contract as of March 31, 2001.

Swaps:

| BFC Contracts | | | |
|---------------|---------|---|--|
| Year | MMBtu | Weighted Average Fixed Price per MMBtu | Derivative Asset/ (Liability) (thousands) |
| 2001 | 428,000 | \$ 2.04 | \$ (1,138) |

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During the first quarter of 2001, payments of \$827,000 were made to the counterparty of this contract. The fair market value of this contract increased by \$621,000 and was recognized as other income.

FOREIGN CURRENCY TRANSLATION - Foreign currency transactions and financial statements are translated in accordance with SFAS No. 52 "Foreign Currency Translation." The Company uses the U.S. dollar as its functional currency, except for CEC, which uses the Canadian dollar. Assets and liabilities related to the operations of CEC are generally translated at current exchange rates, and related translation adjustments are reported as a component of accumulated other comprehensive income in the statement of stockholders' equity. Income statement accounts are translated at the average rates during the period. As a result of the change in the value of the Canadian dollar relative to the U.S. dollar, the Company reported a non cash currency translation loss of \$378,000 for the three months ended March 31, 2001.

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COMPREHENSIVE INCOME - The Company follows the provisions of SFAS No. 130, "Reporting Comprehensive Income." Comprehensive income includes net income and certain items recorded directly to shareholders' equity and classified as other comprehensive income. The following table sets forth the calculation of comprehensive income for the quarters ended March 31, 2001 and 2000.

| | Three Months Ended March 31, | 2001 | |
|---|------------------------------|----------------|-------|
| | ----- | ----- | ----- |
| | | 2001 | |
| | | ----- | ----- |
| | | (in thousands) | |
| Net income | | \$ 1,016 | \$ |
| Other comprehensive income (loss), net of tax: | | | |
| Currency translation adjustment | | (378) | |
| Cumulative effect of changes in accounting principle - January 1, 2001 | | (2,768) | |
| Reclassification adjustment for settled contracts | | 727 | |
| Changes in fair value of outstanding hedging positions | | 516 | |
| | | ----- | ----- |
| Other comprehensive income (loss) | | (1,903) | |
| | | ===== | ===== |
| Comprehensive income (loss) | | \$ (887) | \$ |
| | | ===== | ===== |

EARNINGS (LOSS) PER SHARE - The Company uses the weighted average number of shares outstanding in calculating earnings per share data. When dilutive, options are included as share equivalents using the treasury stock method and are included in the calculation of diluted per share data.

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3. ACQUISITION AND DISPOSITION OF ASSETS:

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ACQUISITION OF CEC RESOURCES LTD. - On February 17, 2000, Carbon completed the acquisition of approximately 97% of the stock of CEC. An offer for exchange of Carbon stock for CEC stock resulted in the issuance of 1,482,826 shares of Carbon stock to holders of CEC stock. The acquisition was accounted for as a purchase. As stated in Note 1 to the financial statements, in February 2001, CEC acquired approximately 34,000 of the 39,000 shares of CEC stock that were not owned by Carbon. Carbon currently owns 99.7% of the stock of CEC.

The following unaudited pro forma information presents a summary of the consolidated results of operations as if the acquisition had occurred at January 1, 2000.

| | THREE MONTHS ENDED MARCH 31, 2000 ----- (unaudited) |
|---------------------|---|
| Total revenue | \$ 5,424,000 |
| Net income | \$ 348,000 |
| Earnings per share: | |
| Basic | \$ 0.06 |
| Diluted | \$ 0.06 |

These unaudited pro forma results have been prepared for comparative purposes only and do not purport to be indicative of results of operations that actually would have resulted had the combination occurred at January 1, 2000, or future results of operations of the consolidated entities.

DISPOSITION OF OIL AND GAS ASSETS - In January 2001, the Company closed the sale of its entire working interest and related leasehold rights in the San Juan Basin, receiving net proceeds of approximately \$6.8 million. The proceeds were used to repay amounts outstanding under the Company's credit facilities and finance the Company's exploration and development program.

4. LONG-TERM DEBT:

UNITED STATES FACILITY - The Company moved its credit facility from U.S. Bank National Association to Wells Fargo Bank West, National Association in the third quarter of 2000.

The facility is an oil and gas reserve based line-of-credit and had a borrowing base of \$16.1 million with outstanding borrowings of \$7.7 million at March 31, 2001. The facility is secured by certain U.S. oil and gas properties of the Company and is scheduled to convert to a term note on October 1, 2002. This facility is scheduled to have a maturity date of either the economic half life of the Company's remaining U.S. based reserves on the last day of the revolving period, or October 1, 2006, whichever is earlier. The facility bears interest at a rate equal to LIBOR plus

1.75% or Wells Fargo Bank West Prime, at the option of the Company. The Company's average borrowing rate was approximately 7.2% at March 31, 2001.

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The borrowing base is based upon the lender's evaluation of the Company's proved oil and gas reserves, generally determined semi-annually.

The credit agreement contains various covenants, which prohibit or limit the Company's ability to pay dividends, purchase treasury shares, incur indebtedness, sell properties or merge with another entity. The Company is also required to maintain certain financial ratios.

CANADIAN FACILITY - The facility with the Canadian Imperial Bank of Commerce (CIBC), has a borrowing base of approximately \$4.4 million with outstanding borrowings of \$2.7 million at March 31, 2001. The Canadian facility is secured by the Canadian oil and gas properties of the Company. The revolving phase of the Canadian facility expired on December 31, 2000 and the Company is currently in negotiations with CIBC to extend the revolving phase to October 2001. However, there can be no guarantee that the Company will be able to successfully negotiate such an extension. If the revolving commitment is not renewed, the loan will be converted into a term loan and will be reduced by consecutive monthly payments over a period not to exceed 36 months. However, subject to possible changes in the borrowing base, CIBC has agreed that it will not require the Company to make any principal payments under the term loan section of the facility until April 2002 at the earliest. As such, no amounts under the CEC facility have been classified as current in the March 31, 2001 balance sheet. The Canadian facility bears interest at the CIBC Prime rate plus 3/4%. The rate was approximately 7.5% at March 31, 2001.

The Canadian facility contains various covenants which limit the Company's ability to pay dividends, purchase treasury shares, incur indebtedness, sell properties, or merge with another entity.

The agreement with CIBC also contains a \$3.0 million swap facility that provides at the Company's request and subject to market availability, commodity swaps covering a portion of the Company's oil and gas production, forward exchange contracts and firm gas purchase and sales transactions. The Company currently utilizes the swap facility to hedge its Canadian production.

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5. BUSINESS AND GEOGRAPHICAL SEGMENTS:

Segment information has been prepared in accordance with Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information" (SFAS No. 131). Carbon has two reportable and geographic segments: BFC and CEC, representing oil and gas operations in the United States and Canada, respectively. The segments are strategic business units which operate in unique geographic locations. The segment data presented below was prepared on the same basis as Carbon's consolidated financial statements.

| | Three Months Ended March 31, 2001 United States | Three Months Ended March 31, 2001 Canada |
|--------------------------|--|---|
| | ----- | ----- |
| Oil and gas sales | \$ 3,801,000 | \$ 4,993,000 |
| Marketing and other, net | 687,000 | - |
| | ----- | ----- |
| Total revenues | 4,488,000 | 4,993,000 |

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| | | |
|---|---------------|---------------|
| Oil and gas production costs | 843,000 | 1,703,000 |
| Depreciation and depletion | 737,000 | 651,000 |
| General and administrative expense, net | 620,000 | 476,000 |
| Interest expense, net | 132,000 | 54,000 |
| | ----- | ----- |
| Total operating expenses | 2,332,000 | 2,884,000 |
| Minority interest in net income | - | 22,000 |
| Income taxes | 809,000 | 908,000 |
| | ----- | ----- |
| Net income before cumulative effect of accounting change | 1,347,000 | 1,179,000 |
| Cumulative effect of accounting change, net of tax | (1,510,000) | - |
| | ----- | ----- |
| Net income (loss) | \$ (163,000) | \$ 1,179,000 |
| | ===== | ===== |
| | ----- | ----- |
| Total assets | \$ 39,496,000 | \$ 18,539,000 |
| | ===== | ===== |

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| | Three Months Ended March 31, 2000 United States | For the Period from February 18 through March 31, 2000 Canada |
|---|--|---|
| | ----- | ----- |
| Oil and gas sales | \$ 2,430,000 | \$ 747,000 |
| Marketing and other, net | 56,000 | - |
| | ----- | ----- |
| Total revenues | 2,486,000 | 747,000 |
| Oil and gas production costs | 826,000 | 196,000 |
| Depreciation and depletion | 945,000 | 205,000 |
| General and administrative expense, net | 438,000 | 113,000 |
| Interest expense, net | 172,000 | 23,000 |
| | ----- | ----- |
| Total operating expenses | 2,381,000 | 537,000 |
| Minority interest in net income | - | 3,000 |
| Income taxes | - | 82,000 |
| | ----- | ----- |
| Net income | \$ 105,000 | \$ 125,000 |
| | ===== | ===== |

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF

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FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS

The following table shows comparative revenue, sales, volumes, average sales prices, expenses and the percentage change between periods for the three months ended March 31, 2001 and 2000 for the Company's United States operations conducted through BFC. The Company's Canadian operations were established in February 2000 through an exchange offer of Carbon shares for shares of CEC Resources. The following table shows comparative pro forma revenue, sales, volumes, average sales prices, expenses and the percentage change between periods as if the acquisition of CEC occurred on January 1, 2000.

| | United States Three Months Ended March 31, | | | |
|--|---|----------|--------|----|
| | 2001 | 2000 | Change | |
| | (Dollars in thousands, except prices and per Mcfe information) | | | |
| Revenues: | | | | |
| Natural gas | \$ 3,179 | \$ 2,026 | 57% | \$ |
| Oil and liquids | 622 | 404 | 54% | |
| Marketing and other, net | 687 | 56 | 1127% | |
| Total revenues | 4,488 | 2,486 | 81% | |
| Sales volumes: | | | | |
| Natural gas (MMcf) | 607 | 845 | -28% | |
| Oil and liquids (Bbl) | 21,490 | 16,252 | 32% | |
| Average price received: | | | | |
| Natural gas (Mcf) | \$ 5.24 | \$ 2.40 | 118% | \$ |
| Oil and liquids (Bbl) | 28.94 | 24.86 | 16% | |
| Direct lifting costs | \$ 291 | \$ 411 | -29% | \$ |
| Average direct lifting costs/Mcfe | 0.40 | 0.44 | -9% | |
| Other production costs | 552 | 415 | 33% | |
| General and administrative, net | \$ 620 | \$ 438 | 42% | \$ |
| Depreciation, depletion and amortization | 737 | 945 | -22% | |
| Interest expense, net | 132 | 172 | -23% | |
| Income tax | 809 | - | n/a | |

(1) Volumetric sales figures for Canadian activities are presented net before royalty interests.

Revenues for oil and gas sales of BFC for the first quarter of 2001 were \$3.8 million, a 56% increase from 2000. The increase was due primarily to increased oil and gas prices partially offset by natural production declines in all operating areas and the divestiture in January 2001 of the Company's entire working interests and related leasehold rights in the San Juan Basin.

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Revenues for oil, liquids and gas sales of CEC for the first quarter of 2001 were \$5.0 million, a 257% increase from the prior year period. The increase was due primarily to increased oil, liquid and gas production and higher oil, liquids and gas prices.

BFC's average production for the first quarter of 2001 was 239 barrels of oil per day and 6.7 million cubic feet (MMcf) of gas per day, a decrease of 22% from the same period in 2000 on a Mcf equivalent (Mcf) basis where one barrel of oil is equal to six Mcf of gas. In January 2001, the Company divested its entire working interests and related leasehold rights in the San Juan Basin. This accounted for more than 50% of the decrease in U.S. natural gas production compared to 2000. The remainder of the decline is primarily due to production declines in all areas. The decrease in natural gas production was partially offset by successful drilling activity in the Piceance Basin. The increase in oil production was due to the successful drilling activities conducted during the fourth quarter of 2000 and the first quarter of 2001 in the Permian Basin, partially offset by natural production declines. During the first quarter of 2001, 9 gross wells and 5.3 net wells were drilled compared to 4 gross wells and 2.6 net wells in 2000.

CEC's average production for the first quarter of 2001 was 243 barrels of oil and liquids per day and 8.9 MMcf of gas per day, an increase of 72% on an Mcfe basis from the same period in 2000. The increase was due primarily to successful drilling and recompletion activities in the Carbon and Rowley areas of Central Alberta. During the first quarter of 2001, 3 gross and net wells were drilled. CEC did not have any drilling activity during the comparable period in 2000.

Average oil prices realized by BFC increased 16% from \$24.86 per barrel for first quarter of 2000 to \$28.94 for 2001. The average oil price includes hedge losses of \$43,000 for the first quarter of 2000. There was no oil hedge activity for 2001. Average natural gas prices realized by BFC increased 118% from \$2.40 per Mcf for the first quarter of 2000 to \$5.24 for 2001. The average natural gas price includes hedge losses of \$529,000 for the first quarter of 2001 compared to hedge gains of \$100,000 for 2000.

Average oil and liquids prices realized by CEC increased 11% from \$24.01 per barrel for the first quarter of 2000 to \$26.56 for 2001. The average oil price includes hedge losses of \$16,000 for the first quarter of 2000. There was no oil hedge activity for 2001. Average natural gas prices realized by CEC increased 140% from \$2.31 per Mcf for the first quarter of 2000 to \$5.55 for 2001. The average natural gas price includes hedge losses of \$720,000 for the first quarter of 2001 compared to hedge losses of \$17,000 for 2000.

Marketing and other revenue realized by BFC was \$687,000 for the first quarter of 2001, compared to \$56,000 for 2000. This increase was due to mark-to-market gains of \$621,000 on a derivative contract that no longer qualified for hedge accounting treatment upon the adoption of SFAS No. 133 on January 1, 2001. In conjunction with the adoption of SFAS 133, the Company recorded a derivative loss (net of tax) of \$1.5 million as the cumulative effect of a change in accounting principle related to this derivative contract.

Direct lifting costs incurred by BFC were \$291,000 or \$.40 per Mcfe for the first quarter of 2001 compared to \$411,000 or \$.44 per Mcfe for 2000. The per Mcfe decrease was primarily due to well workovers in the Permian and Piceance Basins performed in 2000.

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Other production costs incurred by BFC consisting of production taxes and overhead, were \$552,000 for the first quarter of 2001 compared to \$415,000 for 2000. The increase was primarily due to higher severance taxes due to higher prices, partially offset by declines in gas production.

Direct lifting costs incurred by CEC were \$526,000 or \$.57 per Mcfe for the first quarter of 2001 compared to \$188,000 or \$.35 per Mcfe for 2000. The increase was primarily due to increased compression costs, increases in chemical costs to optimize new production and a prior period adjustment for gas processing fees.

Other production costs incurred by CEC consisting of net Crown and other royalty expense were \$1.2 million for the first quarter of 2001 compared to \$167,000 for 2000. The increase was due to a rise in net Crown royalties due to higher oil and gas prices and increased production.

General and administrative expenses incurred by BFC net of overhead reimbursements, increased 42% from \$438,000 for the first quarter of 2000 to \$620,000 for 2001. The increase was primarily due to personnel additions and consulting costs in conjunction with the Company's higher level of capital expenditures, salary increases, and overhead formerly billed on the Company's San Juan Basin properties which were sold in January 2001.

General and administrative expenses incurred by CEC net of overhead reimbursements, increased 110% from \$227,000 for the first quarter of 2000 to \$476,000 for 2001. The increase was primarily due to personnel additions and consulting costs in conjunction with the Company's higher level of capital expenditures and salary increases.

Interest expense incurred by BFC decreased 23% from \$172,000 for the first quarter of 2000 to \$132,000 for 2001. The decrease was due primarily to the proceeds received from the divestiture of the Company's San Juan Basin properties.

Interest expense incurred by CEC increased 23% from \$44,000 for the first quarter of 2000 to \$54,000 for 2001. The increase was due primarily to increased borrowings for drilling and development activity.

Depreciation, depletion and amortization (DD&A) of oil and gas assets are determined based upon the units of production method. This expense is typically dependent upon historical capitalized costs incurred to find, develop and recover oil and gas reserves; however, the Company's current DD&A rate is determined primarily by the purchase price the Company allocated to oil and gas properties in connection with its acquisition of BFC and CEC and the proved reserves the Company acquired in the acquisitions.

DD&A expense incurred by BFC decreased 22% from \$945,000 for the first quarter of 2000 to \$737,000 for 2001. The decrease was due primarily to decreased production. DD&A expense was \$1.00 per Mcfe for the first quarters of 2001 and 2000.

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DD&A expense incurred by CEC increased 59% from \$409,000 for the first quarter of 2000 to \$651,000 for 2001. The increase was due primarily to increased production. DD&A expense was \$.76 per Mcfe for the first quarter of 2000 compared to \$.70 per Mcfe for 2001.

Income tax expense incurred by BFC was \$809,000 for the first quarter of 2001, an effective tax rate of 38%. BFC did not record a provision for income taxes

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for the first quarter of 2000.

Income tax expense incurred by CEC was \$908,000 for the first quarter of 2001, an effective tax rate of 43% compared to \$140,000 and an effective tax rate of 39% for 2000.

FINANCIAL CONDITION AND CAPITAL RESOURCES

At March 31, 2001, Carbon had \$58.0 million of assets. Total capitalization was \$41.8 million, consisting of 75% of stockholders' equity and 25% of debt.

UNITED STATES FACILITY - The Company moved its credit facility from U.S. Bank National Association to Wells Fargo Bank West, National Association in the third quarter of 2000.

The facility is an oil and gas reserve based line-of-credit and had a borrowing base of \$16.1 million with outstanding borrowings of \$7.7 million at March 31, 2001. The facility is secured by certain U.S. oil and gas properties of the Company and is scheduled to convert to a term note on October 1, 2002. This facility is scheduled to have a maturity date of either the economic half life of the Company's remaining U.S. based reserves on the last day of the revolving period, or October 1, 2006, whichever is earlier. The facility bears interest at a rate equal to LIBOR plus 1.75% or Wells Fargo Bank West Prime, at the option of the Company. The Company's average borrowing rate was approximately 7.2% at March 31, 2001. The borrowing base is based upon the lender's evaluation of the Company's proved oil and gas reserves, generally determined semi-annually.

The credit agreement contains various covenants, which prohibit or limit the Company's ability to pay dividends, purchase treasury shares, incur indebtedness, sell properties or merge with another entity. The Company is also required to maintain certain financial ratios.

CANADIAN FACILITY - The facility with the Canadian Imperial Bank of Commerce (CIBC), has a borrowing base of approximately \$4.4 million with outstanding borrowings of \$2.7 million at March 31, 2001. The Canadian facility is secured by the Canadian oil and gas properties of the Company. The revolving phase of the Canadian facility expired on December 31, 2000 and the Company is currently in negotiations with CIBC to extend the revolving phase to October 2001. However, there can be no guarantee that the Company will be able to successfully negotiate such an extension. If the revolving commitment is not renewed, the loan will be converted into a term loan and will be reduced by consecutive monthly payments over a period not to exceed 36 months. However, subject to possible changes in the borrowing base, CIBC has agreed that it will not require the Company to make any principal payments under the term loan section of the facility until April 2002 at the earliest. As such, no amounts under the CEC facility have been classified as current in the March 31, 2001 balance sheet. The Canadian facility bears interest at the CIBC Prime rate plus 3/4%. The rate was approximately 7.5% at March 31, 2001.

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The Canadian facility contains various covenants which limit the Company's ability to pay dividends, purchase treasury shares, incur indebtedness, sell properties, or merge with another entity.

The agreement with CIBC also contains a \$3.0 million swap facility that provides at the Company's request and subject to market availability, commodity swaps covering a portion of the Company's oil and gas production, forward exchange contracts and firm gas purchase and sales transactions. The Company currently

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utilizes the swap facility to hedge its Canadian production.

For the three months ended March 31, 2001, net cash provided by operating activities was \$4.3 million compared to net cash used in operating activities of \$503,000 in 2000. The increase is due primarily to increases in net income and non-cash charges to net income in 2001 compared to 2000. Net cash provided by investing activities was \$399,000 for the three months ended March 31, 2001 compared to net cash used in investing activities of \$1.8 million for 2000. Included in the cash provided by investing activities for the three months ended March 31, 2001, was \$6.8 million in proceeds related to the disposition of the Company's entire working interests and related leasehold rights in the San Juan Basin. The proceeds initially were used to repay debt.

Carbon's primary cash requirements will be to finance acquisitions, exploration and development expenditures, repay debt, and for general working capital needs. However, future cash flow is subject to a number of variables including the level of production and oil and natural gas prices and there can be no assurance that operations and other capital resources will provide cash in sufficient amounts to maintain planned levels of capital expenditures or that increased capital expenditures will not be undertaken. In January 2001, Carbon closed the sale of its entire working interests and related leasehold rights in the San Juan Basin. The proceeds from the sale after adjustments were \$6.8 million. The Company anticipates that capital expenditures, exclusive of acquisitions (if any) or divestitures will approximate \$19.5 million in 2001. Carbon believes that available borrowings under its credit agreements, the proceeds from the sale of San Juan properties, projected operating cash flows and cash on hand will be sufficient to cover its working capital, capital expenditures, planned development activities and debt service requirements for the next 12 months. Nevertheless, Carbon will explore outside funding opportunities including equity or additional debt financings for use in expanding Carbon's operations or in consummating any significant acquisition. Carbon does not know however, whether any financing can be accomplished on terms that are acceptable to the Company.

CERTAIN FACTORS THAT MAY AFFECT FUTURE RESULTS

Statements that are not historical facts contained in this report are forward-looking statements that involve risks and uncertainties that could cause actual results to differ from projected results. Such statements address activities, events or developments that the Company expects, believes, projects, intends or anticipates will or may occur, including such matters as future capital, development and exploration expenditures, drilling of wells, reserve estimates (including estimates of future net revenues associated with such reserves and the present value of such

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future net revenues), future production of oil and natural gas, business strategies, expansion and growth of the Company's operations, cash flow and anticipated liquidity, prospect development and property acquisition, obtaining financial or industry partners for prospect or program development, or marketing of oil and natural gas. Although the Company believes that the expectation reflected in the forward-looking statements and the assumptions upon which such forward-looking statements are based are reasonable, it can give no assurance that such expectation and assumptions will prove to be correct. Factors that could cause actual results to differ materially (Cautionary Disclosures) are described, among other places, in the Marketing, Competition, Government Regulation, Environmental Regulation and Operating Hazards sections of the Company's 2000 Form 10-K and under "Management's Discussion and Analysis of Financial Condition and Results of Operations."

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These factors include, but are not limited to, general economic conditions, the market price of oil and natural gas, the risks associated with exploration, the Company's ability to find, acquire, market, develop and produce new properties, operating hazards attendant to the oil and natural gas business, uncertainties in the estimation of proved reserves and in the projection of future rates of production and timing of development expenditures, the strength and financial resources of the Company's competitors, the Company's ability to find and retain skilled personnel, climatic conditions, labor relations, availability and cost of material and equipment, environmental risks, the results of financing efforts, and regulatory developments. All written and oral forward-looking statements attributable to the Company or persons acting on its behalf are expressly qualified in their entirety by the Cautionary Disclosures.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

Market risk is estimated as the potential change in the fair value of interest sensitive instruments resulting from an immediate hypothetical change in interest rates. The sensitivity analysis presents the change in the fair value of these instruments and changes in the Company's earnings and cash flows assuming an immediate one percent change in floating interest rates. As the Company presently has only floating rate debt, interest rate changes would not affect the fair value of these floating rate instruments but would impact future earnings and cash flows, assuming all other factors are held constant. The carrying amount of the Company's floating rate debt approximates its fair value. At March 31, 2001, the Company had \$7.7 million of floating rate debt through its facility with Wells Fargo Bank West and \$2.7 million through its facility with CIBC. Assuming constant debt levels, earnings and cash flow impacts for the next twelve month period from March 31, 2001 due to a one percent change in interest rates would be approximately \$77,000 before taxes for the facility with Wells Fargo Bank West and \$27,000 before taxes for the facility with the CIBC.

FOREIGN CURRENCY RISK

The Canadian dollar is the functional currency of CEC and is subject to foreign currency exchange rate risk on cash flows related to sales, expenses, financing and investing transactions.

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The Company has not entered into any foreign currency forward contracts or other similar financial investments to manage this risk.

COMMODITY PRICE RISK

Oil and gas commodity markets are influenced by global as well as regional supply and demand. Worldwide political events can also impact commodity prices. The Company from time to time uses certain financial instruments in an attempt to reduce exposure to the market fluctuations in the price of oil and natural gas. The Company's general strategy is to hedge price and location risk of a portion of the Company's production with swap, collar, futures, and floor and ceiling arrangements as described in Note 2 to the financial statements. The Company generally enters into hedges for delivery into one of several pipelines located near producing regions of the Company. Pursuant to Company guidelines, the Company is to engage in these activities only as a hedging mechanism. The Company has a Risk Management Committee to administer its production hedging program. It is the policy of the Company that the Risk Management Committee approves all production hedging

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transactions. Gains or losses from financial instruments that qualify for hedge accounting treatment are recognized as an adjustment to sales revenue when the related transactions being hedged are finalized. Gains or losses from financial instruments that do not qualify for hedge accounting treatment are recognized currently as other income or expense. The cash flows from such agreements are included in operating activities in the consolidated statements of cash flows.

The table below sets forth BFC's and CEC's derivative financial instrument positions that qualify for hedge accounting treatment on its natural gas production as of March 31, 2001.

Futures and swaps:

| BFC Contracts | | | | CEC Contracts | | |
|---------------|---------|---|--|---------------|---------|---|
| Year | MMBtu | Weighted Average Fixed Price per MMBtu | Derivative Asset/ (Liability) (thousands) | Year | MMBtu | Weighted Average Fixed Price per MMBtu |
| 2001 | 680,000 | \$ 2.17 | \$ (2,068) | 2001 | 275,000 | \$ 2.21 |

Collars:

| CEC Contracts | | | | |
|---------------|---------|-------------------------------|---------------------------------|--|
| Year | MMBtu | Average Floor per MMBtu | Average Ceiling per MMBtu | Derivative Asset/ (Liability) (thousands) |
| 2001 | 203,000 | \$ 4.51 | \$ 5.70 | \$ 4 |

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With the adoption of FAS 133 on January 1, 2001, the Company has a derivative contract that no longer qualifies for hedge accounting treatment. The table below sets forth the position of this contract as of March 31, 2001.

Swaps:

| BFC Contracts | | | |
|---------------|-------|---|--|
| Year | MMBtu | Weighted Average Fixed Price per MMBtu | Derivative Asset/ (Liability) (thousands) |

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| | | | |
|-------|---------|---------|------------|
| ----- | ----- | ----- | ----- |
| 2001 | 428,000 | \$ 2.04 | \$ (1,138) |

INFLATION AND CHANGES IN PRICES

While certain of its costs are affected by the general level of inflation, factors unique to the oil and natural gas industry result in independent price fluctuations. Over the past five years, significant fluctuations have occurred in oil and natural gas prices. Although it is particularly difficult to estimate future prices of oil and natural gas, price fluctuations have had, and will continue to have, a material effect on the Company.

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PART II - OTHER INFORMATION

ITEM 1. Not applicable.

ITEM 2. Changes in Securities and Use of Proceeds

During the quarter ended March 31, 2001, the Company issued 6,666 shares of its common stock upon the exercise of outstanding options held by officers or employees of its subsidiaries. The exercise prices for these options resulted in aggregate proceeds to the Company of \$36,000 in cash. The Company believes that these sales of common stock were exempt under Section 4(2) of the Securities Act of 1933 and Rule 506 of Regulation D.

ITEMS 3 - 5. Not applicable

ITEM 6. (a) Exhibits

(b) No reports on Form 8-K were filed by the registrant during the quarter ended March 31, 2001.

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SIGNATURES

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

CARBON ENERGY CORPORATION
Registrant

Date: May 15, 2001

By /s/ Patrick R. McDonald

President and Chief Executive Officer

Date: May 15, 2001

By /s/ Kevin D. Struzeski

Treasurer and
Chief Financial Officer