

ENCORE ACQUISITION CO

Form 10-Q

August 09, 2007

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

(Mark One)

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

**For the quarterly period ended June 30, 2007**

**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: 001-16295**

**ENCORE ACQUISITION COMPANY**

(Exact name of registrant as specified in its charter)

**Delaware**

**75-2759650**

(State or other jurisdiction of  
incorporation or organization)

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

**777 Main Street, Suite 1400, Fort Worth, Texas**

**76102**

(Address of principal executive offices)

(Zip Code)

**(817) 877-9955**

(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 ☒ No ☐

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

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

Number of shares of common stock, \$0.01 par value, outstanding as of August 1, 2007

53,186,851

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**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION**

Certain information included in this Quarterly Report on Form 10-Q (the "Report") and other materials filed with the Securities and Exchange Commission ("SEC"), or in other written or oral statements made or to be made by us, other than statements of historical fact, are forward-looking statements as defined by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements give our current expectations or forecasts of future events. You can identify our forward-looking statements by the fact that they do not relate strictly

to historical or current facts. These statements may include words such as anticipate, estimate, expect, project, intend, plan, believe, should, and other words and terms of similar meaning. Our actual results may differ significantly from the results discussed in the forward-looking statements. Such statements involve risks and uncertainties, including, but not limited to, the matters discussed in Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2006 and in our other filings with the SEC. If one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual outcomes may vary materially from those indicated. You should not place undue reliance on forward-looking statements. Each forward-looking statement speaks only as of the date of the particular statement. We undertake no responsibility to update forward-looking statements for changes related to these or any other factors that may occur subsequent to this filing for any reason.

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**ENCORE ACQUISITION COMPANY  
GLOSSARY OF CERTAIN TERMS**

The following are abbreviations and definitions of certain terms used in this Report:

*Bbl.* One stock tank barrel, or 42 U.S. gallons liquid volume, used in reference to oil or other liquid hydrocarbons.

*Bbl/D.* One Bbl per day.

*BOE.* One barrel of oil equivalent, calculated by converting natural gas to oil equivalent barrels at a ratio of six Mcf of natural gas to one Bbl of oil.

*BOE/D.* One BOE per day.

*Encore or the Company.* Encore Acquisition Company, a Delaware corporation, together with its subsidiaries.

*Gross Wells.* The total number of wells in which we own a working interest.

*High-Pressure Air Injection ( HPAI ).* HPAI involves utilizing compressors to force air under high pressure into previously produced oil and natural gas formations in order to displace remaining resident hydrocarbons and force them under pressure to a common lifting point for production.

*LIBOR.* London Interbank Offered Rate.

*MBbls.* One thousand Bbls.

*Mcf.* One thousand cubic feet of natural gas.

*Mcf/D.* One Mcf per day.

*Net Wells.* Gross wells multiplied by the percentage of the working interest owned by us.

*NYMEX.* New York Mercantile Exchange.

*Proved Developed Reserves.* Reserves that can be expected to be recovered through existing wells with existing equipment and operating methods.

*Proved Reserves.* The estimated quantities of oil, natural gas, and natural gas liquids that geological and engineering data demonstrate with reasonable certainty are recoverable in future years from known reservoirs under existing economic and operating conditions.

See the Company's Annual Report on Form 10-K for the year ended December 31, 2006 for definitions of additional terms that may be used in this Report.

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****ENCORE ACQUISITION COMPANY  
CONSOLIDATED BALANCE SHEETS**

(in thousands, except share and per share amounts)

	<b>June 30, 2007 (unaudited)</b>	<b>December 31, 2006</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 4,938	\$ 763
Accounts receivable	114,770	81,470
Inventory	21,235	18,170
Derivatives	19,552	17,349
Deferred taxes	18,713	24,978
Prepaid expenses	5,272	2,988
Assets held for sale	3,205	
Total current assets	187,685	145,718
Properties and equipment, at cost – successful efforts method:		
Proved properties, including wells and related equipment	2,636,785	2,033,914
Unproved properties	51,482	47,548
Accumulated depletion, depreciation, and amortization	(394,367)	(364,780)
	2,293,900	1,716,682
Other property and equipment	19,772	18,231
Accumulated depreciation	(9,065)	(7,791)
	10,707	10,440
Goodwill	60,606	60,606
Derivatives	29,078	40,715
Long-term receivables	44,748	19,642
Other	34,672	13,097
Total assets	\$ 2,661,396	\$ 2,006,900
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 30,812	\$ 18,204
Accrued liabilities:		
Lease operations expense	12,675	8,582
Development capital	36,833	44,492

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Interest	14,435	11,273
Production, ad valorem, and severance taxes	19,400	10,915
Oil purchases	6,493	11,191
Derivatives	53,220	60,448
Other	24,142	21,358
Total current liabilities	198,010	186,463
Derivatives	28,741	38,688
Future abandonment cost	27,758	19,205
Deferred taxes	278,823	282,825
Long-term debt	1,300,962	661,696
Other	1,290	1,158
Total liabilities	1,835,584	1,190,035

Commitments and contingencies (see Note 14)

Stockholders' equity:

Preferred stock, \$.01 par value, 5,000,000 shares authorized, none issued and outstanding		
Common stock, \$.01 par value, 144,000,000 shares authorized, 53,186,851 and 53,028,866 issued and outstanding, respectively	532	531
Additional paid-in capital	464,246	457,201
Treasury stock, at cost, of 21,288 and 17,809 shares, respectively	(546)	(457)
Retained earnings	380,353	394,917
Accumulated other comprehensive loss	(18,773)	(35,327)
Total stockholders' equity	825,812	816,865
Total liabilities and stockholders' equity	\$ 2,661,396	\$ 2,006,900

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

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**ENCORE ACQUISITION COMPANY**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share amounts)

(unaudited)

	<b>Three months ended June 30,</b>		<b>Six months ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Revenues:				
Oil	\$ 135,596	\$ 92,434	\$ 218,219	\$ 168,549
Natural gas	45,131	39,343	78,109	76,873
Marketing	8,916	25,716	23,857	60,032
Total revenues	189,643	157,493	320,185	305,454
Expenses:				
Production:				
Lease operations	37,552	23,118	68,072	45,854
Production, ad valorem, and severance taxes	19,232	12,580	31,747	24,822
Depletion, depreciation, and amortization	52,318	27,988	87,346	55,008
Exploration	3,415	4,016	14,936	6,025
General and administrative	6,188	5,421	13,548	11,949
Marketing	8,507	24,914	23,518	57,660
Derivative fair value loss	6,766	10,794	52,380	13,100
Other operating	4,751	1,068	7,316	2,596
Total expenses	138,729	109,899	298,863	217,014
Operating income	50,914	47,594	21,322	88,440
Other income (expenses):				
Interest	(27,820)	(10,718)	(44,107)	(22,505)
Other	601	428	1,032	549
Total other income (expenses)	(27,219)	(10,290)	(43,075)	(21,956)
Income (loss) before income taxes	23,695	37,304	(21,753)	66,484
Income tax benefit (provision)	(8,524)	(15,069)	7,496	(26,313)
Net income (loss)	\$ 15,171	\$ 22,235	\$ (14,257)	\$ 40,171
Net income (loss) per common share:				
Basic	\$ 0.29	\$ 0.42	\$ (0.27)	\$ 0.79
Diluted	\$ 0.28	\$ 0.42	\$ (0.27)	\$ 0.78



Weighted average common shares outstanding:

Basic	53,143	52,631	53,111	50,724
Diluted	54,020	53,532	53,111	51,663

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

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**ENCORE ACQUISITION COMPANY**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**

(in thousands)

(unaudited)

	Issued Shares of Common Stock		Additional Paid-in Capital		Shares of Treasury Stock		Accumulated Other Comprehensive Loss		Total Stockholders' Equity
<b>Balance at December 31, 2006</b>	53,047	\$ 531	\$ 457,201		(18)	\$ (457)	\$ 394,917	\$ (35,327)	\$ 816,865
Exercise of stock options and vesting of restricted stock	179	1	1,042						1,043
Purchase of treasury stock					(21)	(546)			(546)
Cancellation of treasury stock	(18)		(150)		18	457	(307)		
Non-cash stock-based compensation			6,153						6,153
Components of comprehensive income:									
Net loss							(14,257)		(14,257)
Amortization of deferred hedge losses, net of tax of \$10,240								16,554	16,554
Total comprehensive income									2,297
<b>Balance at June 30, 2007</b>	53,208	\$ 532	\$ 464,246		(21)	\$ (546)	\$ 380,353	\$ (18,773)	\$ 825,812

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

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**ENCORE ACQUISITION COMPANY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)  
(unaudited)

	<b>Six months ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
Cash flows from operating activities:		
Net income (loss)	\$ (14,257)	\$ 40,171
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depletion, depreciation, and amortization	87,346	55,008
Non-cash exploration expense	13,870	2,580
Deferred taxes	(7,745)	25,211
Non-cash stock-based compensation expense	5,480	4,853
Non-cash derivative	65,038	19,099
Loss on disposition of assets	2,282	472
Other	2,589	2,954
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts receivable	(42,735)	2,205
Current derivatives	(15,303)	
Other current assets	(8,554)	(5,464)
Long-term derivatives	(19,828)	(2,840)
Other assets	(2,200)	(2,019)
Accounts payable	4,468	(1,428)
Other current liabilities	11,127	(2,067)
Other noncurrent liabilities	(253)	(7,259)
Net cash provided by operating activities	81,325	131,476
Cash flows from investing activities:		
Proceeds from disposition of assets	291,454	536
Purchases of other property and equipment	(1,614)	(2,515)
Acquisition of oil and natural gas properties	(779,576)	(15,917)
Development of oil and natural gas properties	(187,227)	(146,959)
Net advances to working interest partners	(24,158)	(1,178)
Other		(342)
Net cash used in investing activities	(701,121)	(166,375)
Cash flows from financing activities:		
Proceeds from issuance of common stock, net of issuance costs		126,890
Exercise of stock options and vesting of restricted stock, net of treasury stock purchases	497	2,822
Proceeds from long-term debt	1,131,500	104,000
Payments on long-term debt	(492,500)	(184,000)

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Debt issuance costs	(11,481)	(200)
Change in cash overdrafts	8,140	(15,606)
Payment of deferred hedge premiums	(12,185)	
Other		2
Net cash provided by financing activities	623,971	33,908
Increase (decrease) in cash and cash equivalents	4,175	(991)
Cash and cash equivalents, beginning of period	763	1,654
Cash and cash equivalents, end of period	\$ 4,938	\$ 663

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

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**ENCORE ACQUISITION COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(unaudited)

**Note 1. About Encore**

Encore is engaged in the acquisition and development of oil and natural gas reserves from onshore fields in the United States. Since 1998, the Company has acquired producing properties with proven reserves and leasehold acreage and grown the production and proven reserves by drilling, exploring, reengineering or expanding existing waterflood projects, and applying tertiary recovery techniques. Encore's properties and oil and natural gas reserves are located in four core areas: the Cedar Creek Anticline ( CCA ) in the Williston Basin of Montana and North Dakota; the Permian Basin of West Texas and southeastern New Mexico; the Rockies, which includes non-CCA assets in the Williston, Big Horn, and Powder River Basins of Wyoming, Montana, and North Dakota and the Paradox Basin of southeastern Utah; and the Mid-Continent area, which includes the Arkoma and Anadarko Basins of Oklahoma, the North Louisiana Salt Basin, the East Texas Basin, and the Barnett Shale of northern Texas.

**Note 2. Basis of Presentation**

The Company's consolidated financial statements include the accounts of wholly-owned and majority-owned subsidiaries and a variable interest entity for which the Company is the primary beneficiary. All material intercompany balances and transactions have been eliminated in consolidation.

In the opinion of management, the accompanying unaudited consolidated financial statements of Encore include all adjustments necessary to present fairly, in all material respects, its financial position as of June 30, 2007, results of operations for the three and six months ended June 30, 2007 and 2006, and cash flows for the six months ended June 30, 2007 and 2006. All adjustments are of a normal recurring nature. These interim results are not necessarily indicative of results for an entire year.

Certain amounts and disclosures have been condensed or omitted from these consolidated financial statements pursuant to the rules and regulations of the SEC. Therefore, these consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto included in the Company's 2006 Annual Report on Form 10-K.

***Variable Interest Entity***

On April 11, 2007, the Company completed the purchase of certain oil and natural gas properties and related assets in the Williston Basin of Montana and North Dakota from certain subsidiaries of Anadarko Petroleum Corporation ( Anadarko ). Prior to closing, Encore assigned all of its rights and duties under the purchase and sale agreement to Encore Operating, L.P., a Texas limited partnership and indirect wholly-owned guarantor subsidiary of Encore, which further assigned all of its rights and duties under the purchase and sale agreement to Encore Exchange, LLC, a Delaware limited liability company unaffiliated with Encore or Encore Operating, L.P. ( Encore Exchange ).

The Williston Basin acquisition was structured to qualify as the first step of a reverse like-kind exchange under Section 1031 of the Internal Revenue Code of 1986, as amended, and I.R.S. Revenue Procedure 2000-37. The Williston Basin assets were acquired by Encore Exchange as an exchange accommodation titleholder. Encore Exchange held the assets pursuant to a qualified exchange accommodation agreement until the second step of the like-kind exchange was completed. During the period the assets were held by Encore Exchange, Encore Operating, L.P. operated the Williston Basin assets pursuant to a management agreement with Encore Exchange. The second step of the like-kind exchange was completed in July 2007 upon the completion of the disposition of certain of Encore's Mid-Continent properties. See Note 3. Acquisitions and Dispositions for additional discussion of the disposition of the Mid-Continent properties.

In connection with the like-kind exchange described above, Encore (through Encore Operating, L.P.) loaned an amount equal to the purchase price to Encore Exchange. Based on the provisions of Financial Accounting Standards Board ( FASB ) Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, the Company determined that Encore Exchange is a variable interest entity for which Encore is the primary beneficiary. Accordingly, Encore Exchange has been consolidated with Encore since April 11, 2007. As of June 30, 2007, Encore Exchange had total assets of approximately \$5.4 million. Subsequent to June 30, 2007, these assets were sold and the like-kind exchange completed. Encore Exchange is currently in the process of being dissolved.

***Reclassifications***

Certain amounts in prior periods have been reclassified to conform to the current period presentation. Specifically, the

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**ENCORE ACQUISITION COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**    **Continued**  
(unaudited)

Company reclassified the net gain/loss from the purchases and sales of third-party oil volumes from Oil revenues to Marketing revenues and Marketing expense and reclassified the related marketing transportation costs from Other operating expense to Marketing expense in the accompanying Consolidated Statements of Operations. These are changes in presentation only and do not affect previously reported net income or earnings per share for either period. The following table details the affected line items from the accompanying Consolidated Statements of Operations for the three and six months ended June 30, 2006:

	<b>Three months ended June 30, 2006</b>	<b>Six months ended June 30, 2006</b>
	(in thousands)	
<b>As Reported:</b>		
Oil revenues	\$94,128	\$172,814
Marketing revenues	\$	\$
Marketing expenses	\$	\$
Other operating expenses	\$ 1,960	\$ 4,489
<b>As Reclassified:</b>		
Oil revenues	\$92,434	\$168,549
Marketing revenues	\$25,716	\$ 60,032
Marketing expenses	\$24,914	\$ 57,660
Other operating expenses	\$ 1,068	\$ 2,596

***New Accounting Pronouncements***

*Statement of Financial Accounting Standards ( SFAS ) No. 157, Fair Value Measurements ( SFAS 157 )*

In September 2006, the FASB issued SFAS 157. SFAS 157 standardizes the definition of fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures related to the use of fair value measures in financial statements. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Encore does not expect the implementation of SFAS 157 to have a material impact on its results of operations or financial condition.

*SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115 ( SFAS 159 )*

In February 2007, the FASB issued SFAS 159. SFAS 159 permits entities to measure many financial instruments and certain other assets and liabilities at fair value on an instrument-by-instrument basis. This statement allows entities to measure eligible items at fair value at specified election dates, with resulting changes in fair value reported in earnings. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Encore does not expect the implementation of SFAS 159 to have a material impact on its results of operations or financial condition.

*FASB Staff Position ( FSP ) on FASB Interpretation ( FIN ) 39-1, Amendment of FASB Interpretation No. 39 ( FSP FIN 39-1 )*

In April 2007, the FASB issued FSP FIN 39-1. FSP FIN 39-1 amends FIN 39, *Offsetting of Amounts Related to Certain Contracts* ( FIN 39 ), to permit a reporting entity that is party to a master netting arrangement to offset the fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) against fair value amounts recognized for derivative instruments that have been offset under the same master netting arrangement in accordance with FIN 39. FSP FIN 39-1 is effective for fiscal years beginning after

November 15, 2007. Encore does not expect the implementation of FSP FIN 39-1 to have a material impact on its results of operations or financial condition.

*FSP FIN 48-1, Definition of Settlement in FASB Interpretation No. 48 ( FSP FIN 48-1 )*

In May 2007, the FASB issued FSP FIN 48-1, which amends FIN No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109* ( FIN 48 ), to provide guidance on how an entity should determine whether a tax



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**ENCORE ACQUISITION COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**    **Continued**  
(unaudited)

position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. FSP FIN 48-1 clarifies that a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits if the taxing authority has completed all of its required or expected examination procedures, the enterprise does not intend to appeal or litigate any aspect of the tax position, and it is considered remote that the taxing authority would reexamine the tax position. This guidance is effective upon initial adoption of FIN 48, which was adopted by Encore on January 1, 2007. Encore retrospectively adopted the provisions of FSP FIN 48-1 effective January 1, 2007, which did not have an impact on its results of operations or financial condition.

**Note 3. Acquisitions and Dispositions*****Acquisitions***

On January 23, 2007, the Company entered into a purchase and sale agreement with certain subsidiaries of Anadarko to acquire oil and natural gas properties and related assets in the Williston Basin of Montana and North Dakota. The closing of the Williston Basin acquisition occurred on April 11, 2007 after which time the operations have been included with those of the Company.

The total purchase price for the Williston Basin assets was approximately \$393.7 million, including transaction costs of \$1.2 million. Based on currently available information, the calculation of the total purchase price and the estimated allocation to the fair value of the Williston Basin assets acquired and liabilities assumed from Anadarko are as follows as of June 30, 2007 (in thousands):

**Calculation of total purchase price:**

Cash paid to Anadarko	\$ 392,467
Estimated transaction costs	1,200
Total purchase price	\$ 393,667

**Allocation of purchase price to the fair value of net assets acquired:**

Proved properties, including wells and related equipment	\$ 379,956
Unproved properties	16,134
Other	4,178
Total assets acquired	400,268
Current liabilities	(3,095)
Future abandonment cost	(3,506)
Total liabilities assumed	(6,601)
Fair value of net assets acquired	\$ 393,667

At June 30, 2007, the Company was awaiting final post close on the Williston Basin acquisition, which will contain certain customary purchase price adjustments.

On January 16, 2007, the Company entered into a purchase and sale agreement with certain subsidiaries of Anadarko to acquire oil and natural gas properties and related assets in the Big Horn Basin of Wyoming and Montana, which included oil and natural gas properties and related assets in or near the Elk Basin field in Park County, Wyoming and Carbon County, Montana and oil and natural gas properties and related assets in the Gooseberry field in Park County, Wyoming. The closing of the Big Horn Basin acquisition occurred on March 7, 2007 after which time

the operations have been included with those of the Company. Prior to closing, Encore assigned the rights and duties under the purchase and sale agreement relating to the Elk Basin assets to Encore Energy Partners Operating LLC ( EEPO ), a Delaware limited liability company and indirect wholly-owned non-guarantor subsidiary of Encore, and the rights and duties under the purchase and sale agreement relating to the Gooseberry assets to Encore Operating, L.P. At closing, EEPO paid the sellers approximately \$328.4 million for the Elk Basin assets, and Encore Operating, L.P. paid the sellers approximately \$63.7 million for the Gooseberry assets.

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**ENCORE ACQUISITION COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**    **Continued**  
(unaudited)

The total purchase price for the Big Horn Basin assets was approximately \$393.3 million, including transaction costs of approximately \$1.2 million. Based on currently available information, the calculation of the total purchase price and the estimated allocation to the fair value of the Big Horn Basin assets acquired and liabilities assumed from Anadarko are as follows as of June 30, 2007 (in thousands):

**Calculation of total purchase price:**

Cash paid to Anadarko	\$ 392,085
Estimated transaction costs	1,200
Total purchase price	\$ 393,285

**Allocation of purchase price to the fair value of net assets acquired:**

Proved properties, including wells and related equipment	\$ 392,375
Intangibles	7,656
Other	2,524
Total assets acquired	402,555
Current liabilities	(2,297)
Future abandonment cost	(6,973)
Total liabilities assumed	(9,270)
Fair value of net assets acquired	\$ 393,285

At June 30, 2007, the Company was awaiting final post close on the Big Horn Basin acquisition, which will contain certain customary purchase price adjustments. The properties and equipment amount in the Big Horn Basin purchase price allocation includes the fair value of proved leasehold costs, lease and well equipment (including flue gas reinjection facilities used to maintain reservoir pressure by compressing and reinjecting the natural gas produced), and an oil pipeline and natural gas pipeline used primarily to transport production from the acquired fields. NGLs are produced as a byproduct of the flue gas tertiary recovery project and are sold at market prices. The revenues generated by these hydrocarbon liquids are included in Oil revenues in the accompanying Consolidated Statements of Operations. Third party revenues and expenses related to the pipelines are included in Marketing revenues and Marketing expense, respectively, in the accompanying Consolidated Statements of Operations.

Encore financed the Big Horn Basin and Williston Basin acquisitions through borrowings under its revolving credit facilities. The operating results related to the Big Horn Basin and Williston Basin assets are included in Encore's operating results from the date of closing forward. As of December 31, 2006, estimated total proved reserves associated with the Big Horn Basin and Williston Basin acquisitions were 38,934 MBOE, 92 percent of which were oil and 90 percent of which were proved developed.

See Note 8. Debt for additional discussion of the Company's revolving credit facilities. See Note 13. Financial Statements of Subsidiary Guarantors below for a discussion of the Company's guarantor and non-guarantor subsidiaries.

***Dispositions***

On June 29, 2007, the Company completed the sale of certain oil and natural gas properties in the Mid-Continent for net proceeds of approximately \$293.6 million and recorded a loss on sale of \$2.3 million. The disposed properties

included certain properties in the Anadarko and Arkoma fields. The Company retained a material oil and natural gas interest in the Anadarko and Arkoma fields and remains active in those areas. Subsequent to June 30, 2007, additional Mid-Continent properties that were subject to exercises of preferential rights were sold for net cash proceeds of \$5.5 million. Assets held for sale related to these properties were \$3.2 million as of June 30, 2007. Proceeds from the Mid-Continent disposition were used to reduce outstanding borrowings under the Company's revolving credit facilities. As of December 31, 2006, estimated total proved reserves associated with the Mid-Continent disposition were 17,416 MBOE, 92 percent of which were natural gas and 75 percent of which were proved developed.

***Pro Forma***

The following unaudited pro forma combined condensed financial data for the three and six months ended June 30, 2007 and 2006 was derived from the historical financial statements of Encore and from the accounting records of Anadarko to give

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effect to the Big Horn Basin and Williston Basin asset acquisitions and the Mid-Continent disposition as if they had occurred on January 1, 2006. The unaudited pro forma combined condensed financial information has been included for comparative purposes only and is not necessarily indicative of the results that might have occurred had the Big Horn and Williston acquisitions and the Mid-Continent disposition taken place as of the dates indicated and are not intended to be a projection of future results.

	<b>Three months ended</b>		<b>Six months ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	(in thousands, except per share amounts)			
Pro forma total revenues	\$ 172,186	\$ 198,204	\$ 327,763	\$ 376,068
Pro forma net income (loss)	\$ 15,079	\$ 24,484	\$ (10,824)	\$ 42,447
Pro forma net income (loss) per common share:				
Basic	\$ 0.28	\$ 0.47	\$ (0.20)	\$ 0.84
Diluted	\$ 0.28	\$ 0.46	\$ (0.20)	\$ 0.82

**Note 4. Inventory**

Inventory is comprised principally of materials and supplies and oil in pipelines, which are stated at the lower of cost (determined on an average basis) or market. Oil produced at the lease which resides unsold in pipelines is carried at an amount equal to its operating costs to produce. Oil in pipelines purchased from third parties is carried at average purchase price. The Company's inventory consisted of the following as of the dates indicated:

	<b>June 30, 2007</b>	<b>December 31, 2006</b>
	(in thousands)	
Materials and supplies	\$ 12,738	\$ 11,784
Oil in pipelines	8,497	6,386
Total inventory	\$ 21,235	\$ 18,170

**Note 5. Proved Properties**

Amounts shown in the accompanying Consolidated Balance Sheets as Proved properties include leasehold costs and wells and related equipment, both completed and in process, and consisted of the following as of the dates indicated:

	<b>June 30, 2007</b>	<b>December 31, 2006</b>
	(in thousands)	
Proved leasehold costs	\$ 1,298,310	\$ 796,932
Wells and related equipment    Completed	1,305,869	1,200,938
Wells and related equipment    In process	32,606	36,044

Total proved properties	\$ 2,636,785	\$ 2,033,914
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**Note 6. Derivative Financial Instruments**

The Company had \$50.4 million of deferred premiums payable recorded at June 30, 2007, of which \$22.8 million is considered long-term and is recorded in Derivatives in the non-current liabilities section of the accompanying Consolidated Balance Sheet and \$27.6 million is considered current and is recorded in Derivatives in the current liabilities section of the accompanying Consolidated Balance Sheet. The premiums relate to various oil and natural gas floor contracts and are payable on a monthly basis from July 2007 to January 2010. The Company recorded these amounts at their net present value at the time the contract was entered into and accretes that value up to the eventual settlement price by recording interest expense each period.

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**Commodity Contracts    Mark-to-Market Accounting: Previously designated as hedges**

Prior to July 2006, the Company used hedge accounting for certain of its derivative contracts, whereby the effective portion of changes in the fair value of the contract was deferred in accumulated other comprehensive loss ( AOCL ) included in stockholders' equity in the accompanying Consolidated Balance Sheets rather than recognized in earnings. In the third quarter of 2006, the Company elected to discontinue hedge accounting prospectively for all remaining commodity derivatives which were previously accounted for as hedges. While this change has no effect on cash flows, results of operations are affected by mark-to-market gains and losses, which fluctuate with the swings in oil and natural gas prices. The deferred loss in AOCL at the time of dedesignation is being amortized to oil and natural gas revenues over the original term of the contracts. The amortization of these amounts is included in oil and natural gas revenues with the revenues from the hedged production. All mark-to-market gains and losses from July 2006 forward are recognized in earnings through Derivative fair value loss in the accompanying Consolidated Statements of Operations rather than deferring such amounts in AOCL.

The following tables summarize the Company's open commodity derivative instruments as of June 30, 2007:

*Oil Derivative Instruments*

Period		Daily	Average	Daily	Average	Daily	Average	Asset
		Floor	Floor	Short	Short	Swap	Swap	(Liability)
		Volume	Price	Floor	Floor	Volume	Price	Fair Market
		(Bbl)	(per Bbl)	(Bbl)	(per Bbl)	(Bbl)	(per Bbl)	Value
								(in thousands)
July	Dec. 2007	14,500	\$ 56.72		\$	3,000	\$ 36.75	\$ (17,410)
Jan.	June 2008	18,500	62.84	(4,000)	50.00	1,000	58.59	7,571
July	Dec. 2008	14,500	63.62	(4,000)	50.00			10,403
Jan.	Dec. 2009	6,000	68.83	(5,000)	50.00	1,000	68.70	9,691
								\$ 10,255

*Natural Gas Derivative Instruments*

Period		Daily	Average	Daily	Average	Daily	Average	Asset
		Floor	Floor	Cap	Cap	Swap	Swap	Fair
		Volume	Price	Volume	Price	Volume	Price	Market
		(Mcf)	(per Mcf)	(Mcf)	(per Mcf)	(Mcf)	(per Mcf)	Value
								(in thousands)
July	Dec. 2007	36,500	\$ 6.85	2,000	\$ 9.85	10,000	\$ 4.99	\$ 1,782
Jan.	Dec. 2008	24,000	6.58	2,000	9.85			4,265
Jan.	Dec. 2009	4,000	7.70	2,000	9.85			754
								\$ 6,801

**Commodity Contracts    Mark-to-Market Accounting: Floor Spreads**

In order to partially finance the cost of premiums on certain purchased floors, the Company may sell floors with a strike price below the strike price of the purchased floor. Together the two floors, known as a floor spread or put

spread, have a lower premium cost than a traditional floor contract but provide price protection only down to the strike price of the short floor. During 2006, the Company entered into floor spreads with a \$70 per Bbl purchased floor and a \$50 per Bbl short floor for 4,000 Bbls/D in 2008 and 5,000 Bbls/D in 2009. As with the Company's other derivative contracts, these are marked-to-market each quarter through Derivative fair value loss in the accompanying Consolidated Statements of Operations. In the above table, the purchased floor component of these floor spreads has been included with the Company's other floor contracts and the short floor component is shown separately as negative volumes.



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***Commodity Contracts    Current Period Impact***

As a result of derivative transactions for oil and natural gas, the Company recognized a pre-tax reduction in oil and natural gas revenues of approximately \$13.4 million and \$14.8 million during the three months ended June 30, 2007 and 2006, respectively, and \$26.8 million and \$31.3 million during the six months ended June 30, 2007 and 2006, respectively. The Company also recognized derivative fair value gains and losses related to (i) changes in the market value since the date of dedesignation of derivative contracts which were previously designated as hedges, (ii) changes in the market value of certain other commodity derivatives that were never designated as hedges, (iii) settlements on derivative contracts not designated as hedges, and (iv) ineffectiveness of derivative contracts designated as hedges prior to July 2006. The following table summarizes the components of derivative fair value loss for the three and six months ended June 30, 2007 and 2006:

	<b>Three months ended June 30,</b>		<b>Six months ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	(in thousands)			
Ineffectiveness on designated cash flow hedges	\$	\$ (1,091)	\$	\$ 1,748
Mark-to-market loss on commodity contracts not designated as hedges	10,315	12,368	64,125	13,461
Settlements on commodity contracts	(3,549)	(483)	(11,745)	(2,109)
Total derivative fair value loss	\$ 6,766	\$ 10,794	\$ 52,380	\$ 13,100

***Commodity Contracts    Future Period Impact***

At June 30, 2007 and December 31, 2006, AOCL consisted entirely of deferred losses on commodity derivatives, net of tax, of \$18.8 million and \$35.3 million, respectively.

During the twelve months ending June 30, 2008, the Company expects to reclassify the remaining \$29.7 million of deferred losses associated with its dedesignated commodity contracts from AOCL to oil and natural gas revenues. The Company also expects to reclassify the remaining \$10.9 million of net deferred tax assets from AOCL to income tax benefit during the twelve months ending June 30, 2008.

**Note 7. Asset Retirement Obligations**

The Company's primary asset retirement obligations relate to future plugging and abandonment expenses on oil and natural gas properties and related facilities disposal. The Company does not include a market risk premium in its risk estimates because a reliable estimate cannot be determined. As of June 30, 2007, the Company had \$5.5 million held in an escrow account from which funds are released only for reimbursement of plugging and abandonment expenses on its Bell Creek property. This amount is included in Other assets in the accompanying Consolidated Balance Sheet. The following table summarizes the changes in the Company's future abandonment liability, the long-term portion of which is recorded in Future abandonment cost on the accompanying Consolidated Balance Sheets, for the six months ended June 30, 2007 (in thousands):

Future abandonment liability at January 1, 2007	\$ 19,841
Wells drilled	59
Accretion of discount	531
Plugging and abandonment costs incurred	(253)
Revision of estimates	(604)
Disposition of properties	(959)
Acquisition of properties	10,448

Future abandonment liability at June 30, 2007

\$ 29,063

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**Note 8. Debt**

The Company's long-term debt consisted of the following as of the dates indicated:

	<b>June 30, 2007</b>	<b>December 31, 2006</b>
	(in thousands)	
Revolving credit facilities	\$ 707,000	\$ 68,000
6 1/4% Notes	150,000	150,000
6% Notes, net of unamortized discount of \$4,670 and \$4,892, respectively	295,330	295,108
7 1/4% Notes, net of unamortized discount of \$1,368 and \$1,412, respectively	148,632	148,588
Total	\$ 1,300,962	\$ 661,696

***Revolving Credit Facilities*****Encore Acquisition Company Senior Secured Credit Agreement**

On March 7, 2007, Encore entered into a five-year amended and restated credit agreement (the "Encore Credit Agreement") with a bank syndicate comprised of Bank of America, N.A. and other lenders, which amended and restated Encore's Amended and Restated Credit Agreement dated as of August 19, 2004, as amended.

The Encore Credit Agreement provides for revolving credit loans to be made to Encore from time to time and letters of credit to be issued from time to time for the account of Encore or any of its restricted subsidiaries. The aggregate amount of the commitments of the lenders under the Encore Credit Agreement is \$1.25 billion. Availability under the Encore Credit Agreement is subject to a borrowing base, which was \$900 million at June 30, 2007. The borrowing base is redetermined semi-annually and upon requested special redeterminations.

The Encore Credit Agreement matures on March 7, 2012. Encore's obligations under the Encore Credit Agreement are secured by a first-priority security interest in Encore's and its restricted subsidiaries' proved oil and natural gas reserves and in the equity interests of Encore's restricted subsidiaries. In addition, Encore's obligations under the Encore Credit Agreement are guaranteed by its restricted subsidiaries.

Loans under the Encore Credit Agreement are subject to varying rates of interest based on (i) the total amount outstanding in relation to the borrowing base and (ii) whether the loan is a Eurodollar loan or a base rate loan. Eurodollar loans bear interest at the Eurodollar rate plus the applicable margin indicated in the following table, and base rate loans bear interest at the base rate plus the applicable margin indicated in the following table:

<b>Ratio of Total Outstandings to Borrowing Base</b>	<b>Applicable Margin for Eurodollar Loans</b>	<b>Applicable Margin for Base Rate Loans</b>
Less than .50 to 1	1.000%	0.000%
From .50 to 1 but less than .75 to 1	1.250%	0.000%
From .75 to 1 but less than .90 to 1	1.500%	0.250%
Greater than or equal to .90 to 1	1.750%	0.500%

The Eurodollar rate for any interest period (either one, two, three or six months, as selected by Encore) is the rate per year equal to LIBOR, as published by Reuters or another source designated by Bank of America, N.A., for deposits in dollars for a similar interest period. The base rate is calculated as the higher of (i) the annual rate of interest announced by Bank of America, N.A. as its prime rate and (ii) the federal funds effective rate plus 0.5 percent.

As of June 30, 2007, the aggregate principal amount of loans outstanding under the Encore Credit Agreement was \$592 million and the aggregate face amount of outstanding letters of credit was \$20 million, all of which related to the

Company's joint development agreement with ExxonMobil Corporation (ExxonMobil) (see Note 14 for additional discussion of this agreement). Any outstanding letters of credit reduce the availability under the Encore Credit Agreement. Borrowings under the Encore Credit Agreement may be repaid from time to time without penalty.

The Encore Credit Agreement contains covenants that include, among others:

- a prohibition against incurring debt, subject to permitted exceptions;

- a prohibition against paying dividends or making distributions, purchasing or redeeming capital stock, or prepaying indebtedness, subject to permitted exceptions;

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indebtedness, subject to permitted exceptions;

a restriction on creating liens on Encore's and its restricted subsidiaries' assets, subject to permitted exceptions;

restrictions on merging and selling assets outside the ordinary course of business;

restrictions on use of proceeds, investments, transactions with affiliates, or change of principal business;

a provision limiting oil and natural gas hedging transactions (other than puts) to a volume not exceeding 75 percent of anticipated production from proved producing reserves;

a requirement that Encore maintain a ratio of consolidated current assets to consolidated current liabilities of not less than 1.0 to 1.0; and

a requirement that Encore maintain a ratio of consolidated EBITDA (as defined in the Encore Credit Agreement) to the sum of consolidated net interest expense plus letter of credit fees of not less than 2.5 to 1.0.

The Encore Credit Agreement contains customary events of default. If an event of default occurs and is continuing, lenders with a majority of the aggregate commitments may require Bank of America, N.A. to declare all amounts outstanding under the Encore Credit Agreement to be immediately due and payable. The Company was in compliance with all of the debt covenants under the Encore Credit Agreement as of June 30, 2007.

Encore incurs a commitment fee on the unused portion of the Encore Credit Agreement determined based on the ratio of amounts outstanding under the Encore Credit Agreement to the borrowing base in effect on such date. The following table summarizes the calculation of the commitment fee under the Encore Credit Agreement:

<b>Ratio of Total Outstandings to Borrowing Base</b>	<b>Commitment Fee Percentage</b>
Less than .50 to 1	0.250%
From .50 to 1 but less than .75 to 1	0.300%
From .75 to 1 but less than .90 to 1	0.375%
Greater than or equal to .90 to 1	0.375%

**Encore Energy Partners Operating LLC Credit Agreement**

On March 7, 2007, EEPO entered into a five-year credit agreement (the "EEPO Credit Agreement") with a bank syndicate comprised of Bank of America, N.A. and other lenders. The EEPO Credit Agreement provides for revolving credit loans to be made to EEPO from time to time and letters of credit to be issued from time to time for the account of EEPO or any of its restricted subsidiaries.

The aggregate amount of the commitments of the lenders under the EEPO Credit Agreement is \$300 million. Availability under the EEPO Credit Agreement is subject to a borrowing base, which was \$115 million at June 30, 2007, and EEPO has the option of borrowing up to \$10 million in excess of the borrowing base for a certain period of time following the closing date. The borrowing base is redetermined semi-annually and upon requested special redeterminations.

The EEPO Credit Agreement matures on March 7, 2012. EEPO's obligations under the EEPO Credit Agreement are secured by a first-priority security interest in EEPO's and its restricted subsidiaries' proved oil and natural gas reserves and in the equity interests of EEPO and its restricted subsidiaries. In addition, EEPO's obligations under the EEPO Credit Agreement are guaranteed by its direct parent, Encore Energy Partners LP, a Delaware limited partnership (the "Partnership"), and EEPO's restricted subsidiaries. Obligations under the EEPO Credit Agreement are non-recourse to

Encore and its restricted subsidiaries.

Loans under the EEPO Credit Agreement are subject to varying rates of interest based on the same provisions as the Encore Credit Agreement.

As of June 30, 2007, the aggregate principal amount of loans outstanding under the EEPO Credit Agreement was \$115 million and there were no outstanding letters of credit. Any outstanding letters of credit reduce the availability under the EEPO Credit Agreement. Borrowings under the EEPO Credit Agreement may be repaid from time to time without penalty.

The EEPO Credit Agreement contains covenants that include, among others:

a prohibition against incurring debt, subject to permitted exceptions;

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a prohibition against paying dividends or making distributions prior to the IPO Effective Date (as defined in the EEPO Credit Agreement), purchasing or redeeming capital stock, or prepaying indebtedness, subject to permitted exceptions;

a restriction on creating liens on the assets of the Partnership, EEPO and its restricted subsidiaries, subject to permitted exceptions;

restrictions on merging and selling assets outside the ordinary course of business;

restrictions on use of proceeds, investments, transactions with affiliates, or change of principal business;

a provision limiting oil and natural gas hedging transactions (other than puts) to a volume not exceeding 75 percent of anticipated production from proved producing reserves;

a requirement that EEPO maintain a ratio of consolidated current assets to consolidated current liabilities of not less than 1.0 to 1.0;

a requirement that EEPO maintain a ratio of consolidated EBITDA (as defined in the EEPO Credit Agreement) to the sum of consolidated net interest expense plus letter of credit fees of not less than 2.5 to 1.0; and

a requirement that EEPO maintain a ratio of consolidated funded debt (excluding certain related party debt) to consolidated adjusted EBITDA (as defined in the EEPO Credit Agreement) of not more than 3.5 to 1.0.

The EEPO Credit Agreement contains customary events of default. If an event of default occurs and is continuing, lenders with a majority of the aggregate commitments may require Bank of America, N.A. to declare all amounts outstanding under the EEPO Credit Agreement to be immediately due and payable. At June 30, 2007, EEPO was in violation of the EEPO Credit Agreement covenant that requires it to maintain a ratio of consolidated EBITDA (as defined in the EEPO Credit Agreement) to the sum of consolidated net interest expense plus letter of credit fees of not less than 2.5 to 1.0. EEPO requested and obtained a waiver from the bank syndicate for the June 30, 2007 violation. Amounts outstanding under the EEPO Credit Agreement have continued to be classified as long-term debt in the accompanying Consolidated Balance Sheet as Encore has the ability and intent to refinance borrowings, on a long-term basis, should any amounts become due and payable within the next twelve months under the EEPO Credit Agreement. EEPO was in compliance with all other debt covenants under the EEPO Credit Agreement as of June 30, 2007.

EEPO incurs a commitment fee on the unused portion of the EEPO Credit Agreement determined based on the same provisions as the Encore Credit Agreement.

**Note 9. Income Taxes**

The components of the income tax benefit (provision) were as follows for the six months ended June 30, 2007 and 2006:

	<b>Six months ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
	(in thousands)	
Federal:		
Current	\$ (249)	\$ (1,102)
Deferred	7,747	(22,194)

Total federal	7,498	(23,296)
State, net of federal benefit/expense:		
Current		
Deferred	(2)	(3,017)
Total state	(2)	(3,017)
Income tax benefit (provision)	\$ 7,496	\$ (26,313)

The following table reconciles income tax benefit (provision) with income tax at the Federal statutory rate for the six months ended June 30, 2007 and 2006:



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	<b>Six months ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
	(in thousands)	
Income (loss) before income taxes	\$ (21,753)	\$ 66,484
Tax at statutory rate	\$ 7,614	\$ (23,269)
State income taxes, net of federal benefit/expense	519	(1,550)
Enactment of the Texas margin tax		(1,295)
Change in estimated future tax rate	(542)	
Permanent and other	(95)	(199)
Income tax benefit (provision)	\$ 7,496	\$ (26,313)

On January 1, 2007, the Company adopted the provisions of FIN 48. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction and various state jurisdictions. Subject to statutory exceptions that allow for a possible extension of the assessment period, the Company is no longer subject to U.S. federal, state, and local income tax examinations for years prior to 2003.

The Company has performed its evaluation of tax positions and has determined that the adoption of FIN 48 did not have a material impact on the Company's financial condition, results of operations, or cash flows. This evaluation is a review of the appropriate recognition threshold for each tax position recognized in the Company's financial statements. The evaluation included, but was not limited to: (1) a review of documentation of tax positions taken on previous returns including an assessment of whether the Company followed industry practice or the applicable requirements under the tax code, (2) a review of open tax returns (on a jurisdiction by jurisdiction basis) as well as supporting documentation used to support those tax returns, (3) a review of the results of past tax examinations, (4) a review of whether tax returns have been filed in all appropriate jurisdictions, (5) a review of existing permanent and temporary differences, and (6) consideration of any tax planning strategies that may have been used to support realization of deferred tax assets. Based on this evaluation, the Company did not identify any tax positions that did not meet the highly certain positions threshold. As a result, no additional tax expense, interest, or penalties have been accrued as a result of the review.

The Company includes interest assessed by the taxing authorities in Interest expense and penalties related to income taxes in Other expense on its Consolidated Statements of Operations. For the six months ended June 30, 2007 and 2006, the Company recorded only a nominal amount of interest and penalties on certain tax positions.

**Note 10. Earnings Per Share (EPS)**

The following table reflects EPS computations for the three and six months ended June 30, 2007 and 2006:

<b>Three months ended June 30,</b>		<b>Six months ended June 30,</b>	
<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
(in thousands, except per share data)			

**Numerator:**

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Net income (loss)	\$ 15,171	\$ 22,235	\$ (14,257)	\$ 40,171
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**Denominator:**

Denominator for basic EPS:

Weighted average shares outstanding	53,143	52,631	53,111	50,724
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Effect of dilutive options and diluted restricted stock (a)	877	901		939
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