

ReoStar Energy CORP
Form 10QSB
February 14, 2008

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

FORM 10-QSB

Quarterly report under Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended December 31, 2007.

Transition report under Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____.

Commission File Number **000-52316**

REOSTAR ENERGY CORPORATION

Name of small business issuer in its charter

Nevada

(State or other jurisdiction of incorporation
Or organization)

20-8428738

(IRS Employer Identification No.)

3880 Hulen Street, Fort Worth, Texas 76107

(Address of principal executive offices)

(817) 989-7367

(Registrant's telephone number)

Check whether the issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

| <u>Class</u> | <u>Outstanding at January 31, 2008</u> |
|---|--|
| Common Stock, par value \$0.001 per share | 79,831,310 |

REOSTAR ENERGY CORPORATION

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REOSTAR ENERGY CORPORATION

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ReoStar Energy Corporation
(formerly Goldrange Resources, Inc.)
Consolidated Balance Sheet
December 31, 2007
(unaudited)

ASSETS

| | |
|--|---------------|
| Current Assets: | |
| Cash | \$ 431,081 |
| Accounts Receivable: | |
| Oil & Gas | 1,014,129 |
| Related Party | 705,888 |
| Hedging Account | 23,109 |
| Total Current Assets | 2,174,207 |
| Note Receivable | 1,405,313 |
| Oil and Gas Properties - successful efforts method | 17,464,612 |
| Less Accumulated Depletion and Depreciation | (3,549,706) |
| Oil & Gas Properties (net) | 13,914,906 |
| Other Depreciable Assets: | 1,475,435 |
| Less Accumulated Depreciation | (63,435) |
| Other Depreciable Assets (net) | 1,412,000 |
| Investment in Carnegie Oil & Gas LLC | 175,000 |
| Total Assets | \$ 19,081,426 |

LIABILITIES

| | |
|---------------------------------------|------------|
| Current Liabilities: | |
| Accounts Payable | \$ 292,479 |
| Payable to Related Parties | 250,750 |
| Royalties Payable | 48,345 |
| Accrued Expenses | 1,040,040 |
| Current Portion of Long-Term Debt | 100,000 |
| Total Current Liabilities | 1,731,614 |
| Notes Payable | 1,605,859 |
| Notes Payable - Related Parties | 3,518,924 |
| Less Current Portion of Notes Payable | (100,000) |
| Total Long-Term Debt | 5,024,783 |

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| | |
|---|---------------|
| Deferred Tax Liability | 2,486,879 |
| Total Liabilities | 9,243,276 |
| Commitments & Contingencies: | - |
| Contingent Stock Based Compensation | 464,986 |
| Stockholders' Equity | |
| Common Stock, \$.001 par, 200,000,000 shares authorized and 79,831,310 shares outstanding on December 31, 2007 | 79,831 |
| Additional Paid-In-Capital | 9,147,072 |
| Retained Earnings | 146,261 |
| Total Stockholders' Equity | 9,373,164 |
| Total Liabilities & Stockholders' Equity | \$ 19,081,426 |

See Accompanying Notes to Consolidated Financial Statements

ReoStar Energy Corporation
(formerly Goldrange Resources, Inc.)
Consolidated Statements of Operations

| | Three Months Ended | | Nine Months | Twelve |
|--|--------------------|----------------|------------------------|-------------------------------|
| | Dec. 31, 2007 | Sept. 30, 2007 | Ended Dec. 31, 2007 | Months Ended Dec. 31, 2006 |
| | (unaudited) | (unaudited) | (unaudited) | (audited) |
| Revenues | | | | |
| Oil & Gas Sales | \$ 1,597,018 | \$ 1,019,222 | \$ 3,430,164 | \$ 2,874,291 |
| Sale of Leases | - | 307,028 | 307,028 | 400,378 |
| Other Income | 80,989 | 79,367 | 160,421 | 45,771 |
| Total Revenue | 1,678,007 | 1,405,617 | 3,897,613 | 3,320,440 |
| Costs and Expenses | | | | |
| Oil & Gas Lease Operating Expenses | 667,420 | 469,112 | 1,470,053 | 1,131,502 |
| Workover Expenses | 16,402 | 22,591 | 38,993 | - |
| Severance & Ad Valorem Taxes | 93,378 | 59,947 | 202,261 | 163,523 |
| Geologic & Geophysical | 8,993 | - | 8,993 | - |
| Delay Rentals | - | 8,571 | 52,186 | - |
| Depletion & Depreciation | 254,721 | 332,245 | 873,097 | 1,856,365 |
| General & Administrative: | - | - | - | 281,727 |
| Salaries & Benefits | 300,393 | 255,371 | 796,733 | - |
| Legal & Professional | 210,451 | 121,953 | 490,253 | - |
| Other General & Administrative | 90,999 | 95,913 | 238,837 | - |
| Interest, net of capitalized interest of \$100,403 and \$126,676 for the three months ended 12/31/2007 and 9/30/2007, respectively | - | - | - | 13,660 |
| Total Costs & Expenses | 1,642,757 | 1,365,703 | 4,171,406 | 3,446,777 |
| Income (Loss) from continuing operations before income taxes | 35,250 | 39,914 | (273,793) | (126,337) |
| Income from discontinued operations: | | | | |
| Pipeline Income | - | - | 35,277 | 319,093 |
| Gain on Sale of Pipeline | (4,389) | (7,952) | 2,232,008 | - |
| Income from discontinued operations | (4,389) | (7,952) | 2,267,285 | 319,093 |
| Interest Income | 61,717 | 70,930 | 155,979 | - |
| Income Tax Provision | (32,403) | (36,013) | (752,316) | - |
| Net Income | \$ 60,175 | \$ 66,879 | \$ 1,397,155 | \$ 192,756 |
| Basic and Diluted Loss per Common Share | | | | |
| | \$ 0.00 | \$ 0.00 | \$ 0.02 | |
| Weighted Average Common Shares Outstanding | | | | |
| | 79,831,310 | 79,711,310 | 78,484,396 | |
| Pro-Forma Earnings Per Share | | | | |
| Net Income | | | \$ | 192,756 |
| Proforma Income Tax Expense at Statutory Rate (35%) | | | | (67,465) |
| Proforma Net Income | | | \$ | 125,291 |
| Proforma Weighted Average Shares Outstanding | | | | |
| | | | | 68,129,310 |
| Proforma Basic & Diluted Earnings Per Share | | | | |
| | | | \$ | 0.00 |

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See Accompanying Notes to Consolidated Financial Statements

ReoStar Energy Corporation
(Formerly Goldrange Resources, Inc.)
Consolidated Statements of Cash Flows

| | Three Months Ended | | Nine Months | |
|--|---------------------------|-----------------------|----------------------|---------------------|
| | Dec. 31, 2007 | Sept. 30, 2007 | Ended | Year Ended |
| | (unaudited) | (unaudited) | Dec. 31, 2007 | Dec 31, 2006 |
| | | | (unaudited) | (audited) |
| Operating Activities: | | | | |
| Net Income | \$ 60,175 | \$ 66,879 | \$ 1,397,155 | \$ 192,756 |
| Adjustments to reconcile net income to cash from operating activities: | | | | |
| Deferred Income Tax Expense | 32,403 | 36,013 | 752,316 | - |
| Depletion, Depreciation, & Amortization | 254,721 | 332,245 | 873,097 | 1,856,365 |
| Note Accretion | - | - | - | 128,334 |
| Stock based compensation | 155,535 | 165,381 | 464,986 | - |
| Joint Venture Partner Expense | 4,389 | 7,952 | 3,084,789 | 332,413 |
| Gain on Sale of Pipeline | - | - | (5,272,701) | - |
| Changes in Operating Assets and Liabilities | | | | |
| Cash Overdraft | - | - | - | 186,912 |
| Changes in Other Assets | - | - | - | (13,455) |
| Changes in Accrued Liabilities | 2,170 | 87,339 | (390,144) | 86,667 |
| Change in Related Party Receivables/Payables | 63,275 | (418,070) | (328,894) | (543,483) |
| Changes in Other Receivables | 737,913 | (737,913) | 63,389 | 2,324 |
| Changes in Hedging Account | (23,109) | - | (23,109) | - |
| Changes in Royalties Payable | 34,511 | 13,834 | 48,345 | - |
| Change in Revenue Receivables | (376,830) | (132,712) | (518,929) | 86,762 |
| Changes in Accounts Payable | (480,182) | 261,006 | (412,307) | - |
| Net Cash provided (used) from operating activities | 464,971 | (318,046) | (262,007) | 2,315,595 |
| Net Cash provided (used) from discontinued operations | (600,046) | (362,292) | 6,202,067 | (2,103,248) |
| Net Cash provided (used) by operating activities and discontinued operations | (135,075) | (680,338) | 5,940,060 | 212,347 |
| Investing Activities: | | | | |
| Oil & Gas Drilling, Completing and Leasehold Acquisition Costs | (2,647,682) | (1,852,728) | (4,944,410) | (6,371,739) |
| Change in Drilling Reimbursements in Excess of Costs | - | - | - | 492,160 |
| Change in Capitalized Note Accretion | 35,000 | 35,000 | 105,000 | - |
| Change in Related Party Payable related to drilling | - | (293,993) | (4,120,568) | 2,220,498 |
| Deposits | - | - | - | 200,000 |
| Investment in Other Depreciable Assets | (102,718) | (454,038) | (1,475,435) | - |
| Investment in Carnegie Oil & Gas LLC | (175,000) | - | (175,000) | - |
| Note Receivable Collections | 60,111 | 67,343 | 208,905 | - |
| Net Cash used in investing activities | (2,830,289) | (2,498,416) | (10,401,508) | (3,459,081) |
| Financing Activities | | | | |
| Notes Payable (Payments) Advances | (75,475) | (79,603) | (2,105,078) | 704,466 |
| Changes in Notes Payable Related Party | (100,000) | - | (100,000) | 1,264,957 |
| Net cash received from common stock subscriptions | - | - | 6,885,353 | - |
| Net Cash provided (used) from financing activities. | (175,475) | (79,603) | 4,680,275 | 1,969,423 |

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| | | | | |
|---------------------------------|-------------|--------------|------------|------------|
| Net Increase (Decrease) in cash | (3,140,839) | (3,258,357) | 218,827 | (931,139) |
| Cash - Beginning of the period | 3,571,920 | 6,830,277 | 212,254 | 1,263,552 |
| Cash - End of the period | \$ 431,081 | \$ 3,571,920 | \$ 431,081 | \$ 332,413 |

See Accompanying Notes to Consolidated Financial Statements

ReoStar Energy Corporation
(Formerly Goldrange Resources, Inc.)
Consolidated Statements of Cash Flows
(Continued)

| | Three Months Ended | | Nine Months | |
|---|--------------------|----------------|---------------|--------------|
| | Dec. 31, 2007 | Sept. 30, 2007 | Dec. 31, 2007 | Year Ended |
| | (unaudited) | (unaudited) | (unaudited) | Dec 31, 2006 |
| | (audited) | | | |
| Supplemental Disclosure of Cash Flow Information | | | | |
| Cash paid during period for: | | | | |
| Interest | \$ 66,789 | \$ 4,337 | \$ 127,111 | \$ 185,284 |
| Income Taxes | \$ - | \$ - | \$ - | \$ - |
| Non Cash Investing and Financing Activities | | | | |
| Stock Based Property Acquisition | \$ - | \$ 298,800 | \$ - | \$ - |

See Accompanying Notes to Consolidated Financial Statements

**REOSTAR ENERGY CORPORATION
(FORMERLY GOLDRANGE RESOURCES, INC.)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(1) BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principals for interim financial information and pursuant to the rules and regulations of the United States Securities and Exchange Commission. They do not include all information and notes required by generally accepted accounting principals for complete financial statements. However, except as disclosed, there has been no material change in the information disclosed in the notes to financial statements included in the Annual Report on Form 10-KSB of ReoStar Energy Corporation for the year ended March 31, 2007. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three-month period ended December 31, 2007 and the nine month period ended December 31, 2007, are not necessarily indicative of the results that may be expected for the year ending March 31, 2008. The financial statements and notes are representations of the Company's management who are responsible for their integrity and objectivity. The Company's accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of these financial statements.

(2) CAPITAL STOCK

We have authorized capital stock of 200 million shares of common stock. There were 79,831,310 shares of common stock issued and outstanding throughout the quarter ended December 31, 2007.

On April 1, 2007, ReoStar entered into employment contracts with certain key employees. In conjunction with the employment contracts, the company approved the issuance of 700,000 shares of restricted stock. Of the 700,000 shares issued, 350,000 shares vest on March 31, 2008, and the balance of the shares will vest on March 31, 2009. For the quarter ended December 31, 2007 and the nine months ended December 31, 2007, Salaries and Benefits included stock related compensation costs of \$145,689 and \$435,448, respectively. For both periods, a liability of an equal amount was recorded as a contingent stock based compensation liability.

On April 1, 2007, ReoStar also entered into a stock option arrangement with two outside members of its board of directors. Both board members received stock options of 50,000 shares with a strike price of \$1.11, one-third of which will vest annually on March 31 2008, 2009, and 2010. For the quarter ended December 31, 2007 and the nine months ended December 31, 2007, other General & Administrative expenses included stock option costs of \$9,845 and \$29,536, respectively. The estimated compensation expense related to the restricted stock grant and stock option grants for the following three year period is shown in the table below:

| | Year Ending March 31 | | |
|-------------------------------|----------------------|------------|----------|
| | 2008 | 2009 | 2010 |
| Restricted Stock Compensation | \$ 581,137 | \$ 195,336 | \$ - |
| Stock Option Compensation | 39,382 | 21,256 | 9,232 |
| | \$ 620,519 | \$ 216,592 | \$ 9,232 |

(3) DISCONTINUED OPERATIONS

Effective May 1, 2007 we sold our entire interest in the Tri-County Gas Gathering System. The sales price was \$15,000,000. The proceeds from the sale were reduced \$900,000 for outstanding capital calls. The proceeds were distributed as follows: \$12.5 million were distributed in June at closing with the balance of \$1.6 million escrowed. Of the escrowed amount, \$600,000 was released in September (90 days after closing) and the balance of \$1 million was released from escrow in December 2007 (180 days after closing). Approximately \$7.9 million of the net proceeds were allocable to the minority interest partners. The following table reflects the calculation of gain from the sale.

| | Dec. 31, 2007 |
|---|---------------|
| Total Proceeds | \$ 15,000,000 |
| Closing adjustment for unpaid capital calls | (900,000) |
| Net Proceeds | 14,100,000 |
| Basis in the pipeline | (8,827,299) |
| Total Gain on sale | 5,272,701 |
| Less Allocations to Minority Interest | (3,040,693) |
| Gain on Sale of Pipeline | \$ 2,232,008 |

(4) OTHER DEPRECIABLE ASSETS

In June 2007, ReoStar formed a wholly owned subsidiary, ReoStar Leasing, Inc. ("RLI"), a Texas corporation. RLI acquired a workover drilling rig and a swab rig near the end of June. In July, RLI began leasing the rigs to the related party operator of its Barnett Shale properties. Effective August 1, 2007, RLI acquired a service rig which was leased to the related party operator of its Corsicana properties. In December, 2007, RLI acquired several large reverse osmosis units which will be used to filter water in our Corsicana polymer flood project. The rigs and reverse osmosis units were included in other depreciable assets on December 31, 2007. The following table summarizes the other depreciable asset holdings at period end.

| | Dec. 31, 2007 |
|--------------------------------|---------------|
| Workover Drilling Rig | \$ 687,777 |
| Swab Rig | 175,000 |
| Service Rig | 200,000 |
| Reverse Osmosis Units | 105,000 |
| Office Equipment & Other | 307,658 |
| Total Other Depreciable Assets | \$ 1,475,435 |

(5) PURCHASE OF LEASES

In late October, ReoStar acquired 710 acres of undeveloped minerals in the Company's core area of operations in the Barnett Shale for \$213,000.

In late December, ReoStar acquired the deep rights on 223 acres in our Corsicana field for \$16,702.

In December, ReoStar re-acquired working interests in 27 of its wells in the Barnett Shale properties. ReoStar paid \$914,446 cash and assumed outstanding lease operating expense payables totaling \$380,796 in exchange for the working interests. The effective date of the transaction was August 1, 2007.

(6) HEDGING LOSS

During the third quarter, the Company initiated its hedging program. The Company purchased put option contracts for 1,000 barrels of oil for delivery each month beginning with February 2008 through July 2008. The delivery price varied from \$83.50 per barrel to \$88.00 per barrel. The put options are marked to market at the end of each quarter. For the quarter ended December 31, 2007, the mark to market adjustment resulted in an unrealized loss of \$6,891.

(7) SUBSEQUENT EVENTS

Effective January 24, 2008, the Company obtained \$550,000 line of credit from its bank. The line of credit matures January 15, 2009, is secured by the Company's equipment, and bears interest at Wall Street Journal prime rate.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

CAUTIONARY STATEMENT

You should read the following discussion and analysis in conjunction with our unaudited condensed consolidated financial statements and the related notes thereto contained elsewhere in this report. The information contained in this quarterly report on Form 10-QSB is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this report and in our other reports filed with the Securities and Exchange Commission, or SEC, including our annual report on Form 10-KSB for the year ended March 31, 2007 and subsequent reports on Form 8-K, which discuss our business in greater detail.

In this report we make, and from time to time we otherwise make, written and oral statements regarding our business and prospects, such as projections of future performance, statements of management's plans and objectives, forecasts of market trends, and other matters that are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Statements containing the words or phrases "will likely result," "are expected to," "will continue," "is anticipated," "estimates," "projects," "believes," "expects," "anticipates," "intends," "target," "goal," "plans," "objective," "should" or similar expressions identify forward-looking statements, which may appear in documents, reports, filings with the Securities and Exchange Commission, news releases, written or oral presentations made by officers or other representatives made by us to analysts, stockholders, investors, news organizations and others, and discussions with management and other of our representatives. For such statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

Our future results, including results related to forward-looking statements, involve a number of risks and uncertainties. Such risks and uncertainties include, but are not limited to, changes in local, regional, and national economic and political conditions, the effect of governmental regulation, competitive market conditions, our ability to obtain additional financing, and other risks detailed herein and from time to time in our SEC reports. No assurance can be given that the results reflected in any forward-looking statements will be achieved. Any forward-looking statement speaks only as of the date on which such statement is made.

Overview of Our Business

We are an independent natural gas and oil company engaged in the acquisition, development, and production of natural gas and oil properties, primarily focused on developmental resource plays and enhanced oil recovery projects located in the Mid-Continent Region of the United States.

ReoStar's development strategy is to acquire acreage positions in resource plays such as the Barnett Shale in North Texas and acreage in mature oil fields that provide the opportunity to increase production through secondary or tertiary recovery techniques. Our objective is to increase reserves and production through internally generated drilling projects coupled with complementary acquisitions. Further, we evaluate various Enhanced Oil Recovery (EOR) techniques to optimize exploitation of mature oil holdings.

During the third quarter, we initiated a hedging program to minimize our downside price risk on oil prices. We purchased put options for 1,000 barrels of oil for six months beginning with February 2008 delivery through August 2008 delivery. The strike price of the put options ranges from \$83.50 through \$88.00 per barrel. We expect to continue the hedging program through the fourth quarter and expect to purchase put options for September through December 2008 delivery during the quarter.

Barnett Shale: We completed our second "cluster" of wells in December, 2007. This cluster was comprised of 4 new wells that were drilled and completed during the quarter and 5 older wells that were re-completed. All nine of the wells were fractured in December within a ten-day period using high pressure stimulation. At the end of the year, all the new drills were in flow-back and were brought online during January and early February, 2008. During the fourth quarter, we expect to drill and complete a cluster of 5 new wells and 4 older wells (re-completions). We also expect to begin drilling two wells which will be part of a cluster that will be completed during the first quarter of the next fiscal year. All wells within a cluster will be fractured using high pressure stimulation within a seven-day period and be brought online simultaneously.

Corsicana: We began injecting a polymer-surfactant solution into our pilot area in mid-June. During the third quarter we injected a total of approximately 600 barrels of the polymer-surfactant solution in 6 injection wells per day. Pressures have slowly been increasing and we have begun to see incremental increases in production in two of the seven producer wells. We will continue to closely monitor the injection process and expect to see continuing improvement in results during the third and fourth quarter of this fiscal year.

We have begun to permit and plan the drilling of the next 13 wells for the second stage of the pilot project. We will begin drilling the wells in mid-February. We also plan to drill 3 deeper exploratory wells in the acreage we acquired in December. Two wells will be drilled in the Pecan Gap formation and the third well will be drilled in the Glen Rose formation.

Successful Efforts Method of Accounting

We account for our exploration and development activities utilizing the successful efforts method of accounting. Under this method, costs of productive exploratory wells, development dry holes and productive wells and undeveloped leases are capitalized. Oil and natural gas lease acquisition costs are also capitalized. Exploration costs, including personnel costs, certain geological and geophysical expenses and delay rentals for oil and natural gas leases, are charged to expense as incurred. Exploratory drilling costs are initially capitalized, but charged to expense if and when the well is determined not to have found reserves in commercial quantities. The sale of a partial interest in a proved property is accounted for as a cost recovery and no gain or loss is recognized as long as this treatment does not significantly affect the unit-of-production amortization rate. A gain or loss is recognized for all other sales of producing properties.

The application of the successful efforts method of accounting requires managerial judgment to determine the proper classification of wells designated as developmental or exploratory which will ultimately determine the proper accounting treatment of the costs incurred. The results from a drilling operation can take considerable time to analyze and the determination that commercial reserves have been discovered requires both judgment and industry experience. Wells may be completed that are assumed to be productive and actually deliver oil and natural gas in quantities insufficient to be economic, which may result in the abandonment of the wells at a later date. The evaluation of oil and natural gas leasehold acquisition costs requires managerial judgment to estimate the fair value of these costs with reference to drilling activity in a given area.

The successful efforts method of accounting can have a significant impact on the operational results reported when we enter a new exploratory area in hopes of finding an oil and natural gas field that will be the focus of future developmental drilling activity. The initial exploratory wells may be unsuccessful and will be expensed. Seismic costs can be substantial which will result in additional exploration expenses when incurred.

Industry Environment

We operate entirely within the United States, a mature region for the exploration and production of oil and gas. The size and frequency of new discoveries of oil and gas in the United States are declining, while finding and development costs are increasing.

We believe that there remain certain areas in the continental United States which are under-explored or have not been fully explored and developed with the benefit of newly available exploration, production and reserve enhancement technology. Examples of such technology include advanced 3-D seismic processing, hydraulic reservoir fracture stimulation, advances in well logging and analysis, and enhanced oil recovery practices.

Larger independent producers and major oil companies have ventured increasingly overseas and offshore, de-emphasizing their onshore United States assets. This movement out of mature basins with significant proven reserves has provided acquisition opportunities for well managed companies that are capable of quickly analyzing opportunities, well positioned financially to quickly close an acquisition, and have the technical expertise to generate additional value from these assets.

In other situations, to increase cash flow without increasing capital spending, larger independent producers and major integrated oil companies have allowed smaller companies the opportunity to explore and develop reserves on their undeveloped acreage through joint ventures and farm-in arrangements.

We believe the acquisition market for natural gas properties has become extremely competitive as producers vie for additional production and expanded drilling opportunities. Acquisition values have reached historic highs, but we expect these values to begin to soften in the near future. We expect drilling and service costs pressures to ease slightly, but expect them to remain at a high level in relative to past pricing. In addition, we expect lease operating expenses to continue to rise as producers are forced to make operational enhancements to maintain production in aging fields.

We derive our revenues from the sale of crude oil and natural gas that is produced from our properties. Revenues are a function of the volume produced and the prevailing market price at the time of sale. The price of oil and natural gas is the primary factor affecting our revenues.

Crude oil and natural gas are commodities. The price that we receive for the crude oil and natural gas we produce is largely a function of market supply and demand. Demand for natural gas in the United States has increased dramatically over the last ten years. Demand is impacted by general economic conditions, estimates of gas in storage, weather and other seasonal condition, including hurricanes and tropical storms. Demand for crude oil has also increased over the last ten years while the increase in supply has not increased proportionately resulting in a tight market. Market conditions involving over or under supply of crude oil and natural gas can result in substantial price volatility. Historically, commodity prices have been volatile and we expect the volatility to continue in the future. A substantial or extended decline in oil and gas prices or poor drilling results could have a material adverse effect on our financial position, results of operations, cash flows, quantities of oil and gas reserves that may be economically produced and our ability to access capital markets.

Principal Components of Our Cost Structure

Direct Operating Expenses. These are day-to-day costs incurred to bring hydrocarbons out of the ground and to the market together with the daily costs incurred to maintain our producing properties. Such costs also include work-over repairs to our oil and gas properties not covered by insurance. To minimize and help control our costs, we have recently acquired a service rig to add to our previously acquired work-over drilling rig and swab rig.

Production and Ad Valorem Taxes. These costs are primarily paid based on a percentage of market prices or at fixed rates established by federal, state or local taxing authorities.

Exploration Expense. The costs include geological and geophysical costs, seismic costs, delay rentals and the costs of unsuccessful wells or dry holes. While our current asset mix requires a minimum of geological and geophysical costs and seismic costs, it is possible this component of our cost structure could sharply increase depending upon future property acquisitions.

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Plugging Costs. The Corsicana field is over one hundred years old and has approximately 200 suspended wells scattered throughout the properties. In order to properly execute our enhanced oil recovery projects, we will plug the suspended wells that have no mechanical integrity. Since the wells are shallow, we are able to plug the well bore at a cost of less than \$1,500 per well and can plug up to 15 wells in one day.

General and Administrative Expense. Overhead, including payroll and benefits for our corporate staff, costs of maintaining our headquarters, costs of finding our working interest partners, costs of managing our production and development operations, audit and other professional fees and legal compliance are included in general and administrative expense. General and administrative expense includes stock-based compensation expense (non-cash) associated with the adoption of SFAS No. 123(R), amortization of restricted stock grants as part of employee compensation.

Interest. We may finance a portion of our working capital requirements and acquisitions with borrowings under a credit facility or with longer term public traded debt securities. As a result, interest expense could become a much more prevalent component of our cost structure. Currently we capitalize all interest associated with acquiring and developing our oil and gas properties.

Depreciation, Depletion and Amortization. As a successful efforts company, we capitalize all costs associated with our acquisition and all successful development and exploration efforts, and apportion these costs to each unit of production through depreciation, depletion and amortization expense. This also includes the systematic, monthly amortization of capitalized interest.

Income Taxes. We are subject to state and federal income taxes but are currently not in a minimal tax paying position for regular federal income taxes, primarily due to the current deductibility of intangible drilling costs ("IDC"). We are also subject to some state income taxes. Currently, virtually all of our federal taxes are deferred; however, at some point, we will utilize all of our net operating loss carry-forwards and we will recognize current income tax expense and continue to recognize current tax expense as long as we are generating taxable income.

Results and Analysis of Financial Condition, Cash Flows and Liquidity

During the quarter ended December 31, 2007, we sold approximately 9,200 barrels of oil compared with 7,775 barrels of oil for the previous quarter, an increase of approximately 18%. Of the oil sold, approximately 550 barrels were attributable to working interests repurchased in December. Excluding the oil attributable to the working interest repurchase, we sold approximately 8,650 barrels of oil, an increase of approximately 11%. In addition to the 9,200 barrels of oil produced and sold during the quarter, we sold 363 barrels of oil produced in the prior quarter attributable to the working interest repurchased in December.

We sold approximately 89,250 mcf of gas for the quarter ended December 31, 2007 compared with 82,030 mcf of gas for the previous quarter, an increase of approximately 9%. Of the gas sold, approximately 15,000 mcf was attributable to working interests repurchased in December. Excluding the gas attributable to the working interest repurchase, we sold approximately 84,500 mcf of gas, an increase of approximately 3%. In addition to the 89,250 mcf of gas produced and sold during the quarter, we sold 10,437 mcf of gas produced in the prior quarter attributable to the working interest repurchased in December.

The average price for natural gas sold during the quarter was \$6.46 per MCF net of transportation, compression and CO2 charges compared with \$6.71 per MCF for the previous quarter. The average price per barrel of oil was \$94.48 compared with \$71.50 per barrel during the previous quarter.

Oil and gas revenues for the quarter ended December 31, 2007 were \$1,597,018, compared with \$1,019,222 during the previous quarter, an increase of 56%. Revenues attributable to the working interest repurchase totaled approximately \$250,000, of which, approximately \$82,000 was attributable to production from the prior quarter. Revenues excluding the effect of the working interest repurchase totaled approximately \$1,350,000, an increase of 32% over the previous quarter.

During the fiscal quarter ended December 31, 2007, we spent approximately \$2.75 million on capital expenditures. For the nine months ended December 31, 2007 we spent approximately \$10.5 million on capital expenditure, of which approximately \$4.1 million related to drilling costs incurred prior to the February 1, 2007 contribution of assets.

On December 31, 2007, we had \$0.4 million in cash and total assets of \$19 million. Debt consisted of payables to non-related parties of \$3.0 million, of which, 1.6 million is long-term. We also had accounts and notes payables to related parties of \$3.8 million.

During the third quarter we retained an investment banking firm to assist us in securing \$20 million in financing. We expect the \$20 million will be split between a long-term credit facility and convertible preferred stock. Of the \$20MM, approximately \$4.5MM will be used to refinance existing debt and approximately \$13.3MM will be used to fund drilling and the purchase of additional leasehold. The balance of the \$20MM will be used for transaction costs and general corporate purposes. We expect to complete the offering in the fourth quarter and anticipate drawing down approximately one-half of the total financing during the fourth quarter.

Cash is required to fund capital expenditures necessary to offset inherent declines in production and reserves (which is typical in the oil and gas industry). The future success of increasing reserves and production will be dependent on capital resources available and the success of finding or acquiring additional reserves. We believe that net cash generated from operating activities and the proceeds from our debt and convertible preferred stock offering will be adequate to satisfy near-term financial obligations and liquidity needs.

However, long-term cash flows are subject to a number of variables including the level of production and prices as well as various economic conditions that have historically affected the oil and gas business. A material drop in oil and gas prices or a reduction in production and reserves would reduce our ability to fund capital expenditures, meet financial obligations and remain profitable. We operate in an environment with numerous financial and operating risks, including, but not limited to, the inherent risks of the search for, development and production of oil and gas, the ability to buy properties and sell production at prices which provide an attractive return and the highly competitive nature of the industry. Our ability to expand our reserve base is, in part, dependent on obtaining sufficient capital through internal cash flow, bank borrowings or the issuance of debt or equity securities. There can be no assurance that internal cash flow and other capital sources will provide sufficient funds to maintain capital expenditures that we believe are necessary to efficiently develop our properties and offset inherent declines in production and proved reserves.

Cash Flow

Our principal sources of cash are operating cash flow, the sale of a portion of the working interest in our Barnett Shale drilling projects, and the issuance of equity securities. Our operating cash flow is highly dependent on oil and gas prices.

Based on current projections and oil and gas futures prices, the balance of the 2007 capital program is expected to be funded with internal cash flow and the proceeds of our debt and convertible preferred stock offering.

Capital Requirements

Our primary needs for cash are for exploration and development of our Barnett Shale properties, establishing the enhanced oil recovery projects in our Corsicana properties, and the acquisition of additional oil and gas properties, both in unconventional gas plays and mature fields. During the year ended December 31, 2006, a predecessor company, REO Energy, Ltd. expended approximately \$24 million on Barnett drilling projects. During the nine months ended December 31, 2007 \$12.3 million of capital was expended on Barnett Shale drilling projects. Our working interest partners contributed approximately \$8.9 for the nine months ended December 31, 2007 toward the Barnett Shale drilling costs. Our retained working interests in the Barnett Shale development program were funded by cash flow from the Barnett Shale properties and cash on hand.

We have initiated phase two of the Corsicana pilot project and we expect to expand the project during the next fiscal year. We plan to drill more than eighty-eight wells, one-third of which will be injection wells, over the next six quarters. This phase will require at least one additional polymer mixing plant. Funding for this phase will be achieved partially through the Company's resources and additional outside capital. Management is considering its options with regards to such funding, which could be as much as \$15 million. As the redevelopment program progresses, we expect the remaining capital requirements will be derived from the project's cash flow. There is no guarantee that such outside capital will be available to us or, if available, it will be on terms acceptable to us.

Cautionary Statement: There can be no assurance that we will be successful in raising capital through private placements or otherwise. Even if we are successful in raising capital through the sources specified, there can be no assurances that any such financing would be available in a timely manner or on terms acceptable to us and our current shareholders. Additional equity financing could be dilutive to our then existing shareholders, and any debt financing could involve restrictive covenants with respect to future capital raising activities and other financial and operational matters.

Future Commitments

In addition to our capital expenditure program, we are committed to making cash payments in the future on two types of contracts: note agreements and operating leases. As of December 31, 2007, we have no capital leases nor have we entered into any material long-term contracts for equipment, nor do we have any off-balance sheet debt or other such unrecorded obligations.

The table below provides estimates of the timing of future payments that we are obligated to make based on agreements in place at December 31, 2007. In addition to the contractual obligations listed on the table below, our balance sheet at December 31, 2007 reflects accrued interest payable on our debt of \$275,239.

| | Fiscal year ended March 31, | | |
|-----------------------------|-----------------------------|--------------|------------|
| | 2008 | 2009 | 2010 |
| Office Lease | \$ 111,000 | \$ 150,000 | \$ 132,000 |
| Mineral Lease Loans | \$ 100,000 | \$ - | \$ - |
| Related Party Notes Payable | \$ - | \$ 3,518,924 | \$ - |

Off-Balance Sheet Arrangements

We do not currently utilize any off-balance sheet arrangements to enhance liquidity and capital resource position, or for any other purpose.

Inflation and Changes in Prices

Our revenues, the value of our assets and our ability to obtain bank loans or additional capital on attractive terms have been and will continue to be affected by changes in oil and gas prices and the costs to produce our reserves. Oil and gas prices are subject to significant fluctuations that are beyond our ability to control or predict. In order to minimize our downside exposure to oil and gas price volatility, we will more than likely begin to hedge our future production during the third quarter.

Although certain of our costs and expenses are affected by general inflation, inflation does not normally have a significant effect on our business. In a trend that began in 2004 and accelerated during 2005 and 2006, commodity prices for oil and gas increased significantly. The higher prices have led to increased activity in the industry and, consequently, rising costs. These costs trends have put pressure not only on our operating costs but also on our capital costs. Industry capital costs have nearly doubled during the last two years. Industry analysts expect the trend to continue during the next fiscal year. We expect demand for vertical drilling rigs in the Barnett Shale to ease during the next fiscal year, which we expect will result in a leveling out of our capital costs during the next fiscal year.

Management's Discussion of Critical Accounting Estimates

Our discussion and analysis of our financial condition and results of operations are based upon consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of our financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at year-end and the reported amounts of revenues and expenses during the year. We base our estimates on historical experience and various other assumptions that we believe are reasonable; however, actual results may differ.

Certain accounting estimates are considered to be critical if (a) the nature of the estimates and assumptions is material due to the level of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to changes; and (b) the impact of the estimates and assumptions on financial condition or operating performance is material.

Oil and Gas Properties

To ensure the reliability of our reserve estimates, we engage independent petroleum consultants to prepare an estimate of proved reserves. Proved reserves are defined by the SEC as those volumes of crude oil, condensate, natural gas liquids and natural gas that geological and engineering data demonstrate with reasonable certainty are recoverable from known reservoirs under existing economic and operating conditions. Proved developed reserves are volumes expected to be recovered through existing wells with existing equipment and operating methods. Although our engineers are knowledgeable of and follow the guidelines for reserves established by the SEC, the estimation of reserves requires engineers to make a significant number of assumptions based on professional judgment. Reserve estimates are updated at least annually and consider recent production levels and other technical information. Estimated reserves are often subject to future revisions, which could be substantial, based on the availability of additional information, including: reservoir performance, new geological and geophysical data, additional drilling, technological advancements, price and cost changes and other economic factors. Changes in oil and gas prices can lead to a decision to start-up or shut-in production, which can lead to revisions to reserve quantities. Reserve revisions in turn cause adjustments in the depletion rates utilized by us. We cannot predict what reserve revisions may be required in future periods.

We monitor our long-lived assets recorded in property, plant and equipment in our consolidated balance sheet to ensure they are fairly presented. We must evaluate our properties for potential impairment when circumstances indicate that the carrying value of an asset could exceed its fair value. A significant amount of judgment is involved in performing these evaluations since the results are based on estimated future events. Such events include a projection of future oil and natural gas sales prices, an estimate of the ultimate amount of recoverable oil and gas reserves that will be produced from a field, the timing of future production, future production costs, future abandonment costs, and future inflation. The need to test a property for impairment can be based on several factors, including a significant reduction in sales prices for oil and/or gas, unfavorable adjustment to reserves, physical damage to production equipment and facilities, a change in costs, or other changes to contracts, environmental regulations or tax laws. All of these factors must be considered when testing a property's carrying value for impairment. We cannot predict whether impairment charges may be required in the future. We are required to develop estimates of fair value to allocate purchase prices paid to acquire businesses to the assets acquired and liabilities assumed under the purchase method of accounting. The purchase price paid to acquire a business is allocated to its assets and liabilities based on the estimated fair values of the assets acquired and liabilities assumed as of the date of acquisition. We use all available information to make these fair value determinations.

Deferred Taxes

We are subject to income and other taxes in all areas in which we operate. When recording income tax expense, certain estimates are required because income tax returns are generally filed many months after the close of a calendar year, tax returns are subject to audit which can take years to complete and future events often impact the timing of when income tax expenses and benefits are recognized. We have deferred tax assets relating to tax operating loss carry forwards and other deductible differences. We routinely evaluate deferred tax assets to determine the likelihood of realization. A valuation allowance is recognized on deferred tax assets when we believe that certain of these assets are not likely to be realized. In determining deferred tax liabilities, accounting rules require OCI to be considered, even though such income or loss has not yet been earned.

At December 31, 2007, deferred tax liabilities exceeded deferred tax assets by \$2.5 million. We may be challenged by taxing authorities over the amount and/or timing of recognition of revenues and deductions in our various income tax returns. Although we believe that we have adequately provided for all taxes, gains or losses could occur in the future due to changes in estimates or resolution of outstanding tax matters.

Contingent Liabilities

A provision for legal, environmental and other contingent matters is charged to expense when the loss is probable and the cost or range of costs can be reasonably estimated. Judgment is often required to determine when expenses should be recorded for legal, environmental and contingent matters. In addition, we often must estimate the amount of such losses. In many cases, our judgment is based on the input of our legal advisors and on the interpretation of laws and regulations, which can be interpreted differently by regulators and/or the courts. We monitor known and potential legal, environmental and other contingent matters and make our best estimate of when to record losses for these matters based on available information. We currently have no material accruals for contingent liabilities.

ITEM 3. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we conducted an evaluation, under the supervision and with the participation of our chief executive officer and chief financial officer of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")). Based upon this evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. There was no change in our internal controls or in other factors that could affect these controls during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are currently not a party to any pending legal proceeding. From time to time, we may receive claims of and become subject to routine litigation that is incidental to the business.

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

Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

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

Not applicable.

ITEM 5. OTHER INFORMATION

Not applicable.

ITEM 6. EXHIBITS

EXHIBIT

| <u>NUMBER</u> | <u>DESCRIPTION</u> |
|---------------|--|
| 10.1 | Purchase and Sale Agreement by and between ReoStar Energy Corporation and United Texas Petroleum, Inc. dated December 4, 2007. (Incorporated by reference to the Form 8-K filed on December 7, 2007) |
| 31.1 | CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | CEO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | CFO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

February 14, 2007

REOSTAR ENERGY CORPORATION

By /s/ Mark S. Zouvas

Mark S. Zouvas, Chief Executive Officer

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