

PANHANDLE OIL & GAS INC

Form 10-Q

August 07, 2008

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

☒ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the period ended June 30, 2008**

☐ **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 001-31759

**PANHANDLE OIL AND GAS INC.**

(Exact name of registrant as specified in its charter)

OKLAHOMA

73-1055775

(State or other jurisdiction of  
incorporation or organization)

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

Grand Centre Suite 300, 5400 N Grand Blvd., Oklahoma City, Oklahoma 73112

(Address of principal executive offices)

Registrant's telephone number including area code (405) 948-1560

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

Outstanding shares of Class A Common stock (voting) at August 5, 2008: 8,375,688

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**PART 1 FINANCIAL INFORMATION**  
**PANHANDLE OIL AND GAS INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(Information at June 30, 2008 is unaudited)

	June 30, 2008	September 30, 2007
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 650,661	\$ 989,360
Oil and gas sales receivables	17,462,297	8,103,250
Fair value of natural gas collar contracts		106,916
Other	1,336,497	112,882
Total current assets	19,449,455	9,312,408
Properties and equipment, at cost, based on successful efforts accounting:		
Producing oil and gas properties	153,094,794	125,634,251
Non-producing oil and gas properties	10,693,152	10,697,854
Other	491,659	625,455
	164,279,605	136,957,560
Less accumulated depreciation, depletion and amortization	81,335,348	68,424,645
Net properties and equipment	82,944,257	68,532,915
Investments	628,403	690,011
Other	258,535	4,463
Total assets	\$ 103,280,650	\$ 78,539,797
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 3,772,164	\$ 1,773,255
Fair value of natural gas collar contracts	3,506,500	
Accrued liabilities	671,033	348,042
Total current liabilities	7,949,697	2,121,297
Long-term debt	10,018,862	4,661,471
Deferred income taxes	21,102,750	16,827,750
Asset retirement obligations	1,247,908	1,247,908
Stockholders' equity:		
Class A voting common stock, \$.0166 par value;	140,524	140,524

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24,000,000 shares authorized, 8,431,502 issued at June 30, 2008 and at September 30, 2007

Capital in excess of par value	2,146,071	2,146,071
Deferred directors' compensation	1,584,743	1,358,778
Retained earnings	61,045,856	50,035,998
	64,917,194	53,681,371
Less treasury stock, at cost; 54,514 shares at June 30, 2008 and no shares at September 30, 2007	(1,955,761)	
Total stockholders' equity	62,961,433	53,681,371
Total liabilities and stockholders' equity	\$ 103,280,650	\$ 78,539,797

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PANHANDLE OIL AND GAS INC.  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
(Unaudited)

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2008	2007	2008	2007
Revenues:				
Oil and gas sales	\$ 20,551,865	\$ 10,181,501	\$ 48,687,560	\$ 26,718,087
Lease bonuses and rentals	32,154	22,560	110,464	193,317
Gains (losses) on natural gas collar contracts	(2,286,789)	560,972	(4,391,316)	588,181
Gain on asset sales, interest and other	105,963	96,388	190,718	274,768
Income of partnerships	50,013	126,925	306,805	289,621
	18,453,206	10,988,346	44,904,231	28,063,974
Costs and expenses:				
Lease operating expenses	2,178,732	888,049	4,977,151	2,621,608
Production taxes	675,206	721,927	2,431,165	1,764,164
Exploration costs	35,394	224,078	397,125	943,489
Depreciation, depletion, and amortization	4,671,193	3,644,062	13,376,346	10,504,001
Provision for impairment	37,666	398,033	385,672	2,027,866
Loss on asset sales	203,387	(1,522)	203,387	254,395
General and administrative	1,164,743	913,077	3,991,566	3,055,791
Interest expense		24,064	44,346	110,541
	8,966,321	6,811,768	25,806,758	21,281,855
Income before provision for income taxes	9,486,885	4,176,578	19,097,473	6,782,119
Provision for income taxes	3,018,000	1,272,500	6,317,000	2,113,293
Net income	\$ 6,468,885	\$ 2,904,078	\$ 12,780,473	\$ 4,668,826
Earnings per common share (Note 4)	\$ 0.76	\$ 0.34	\$ 1.50	\$ 0.55
Weighted average shares outstanding:				
Common shares	8,423,067	8,422,529	8,428,701	8,422,529
Unissued, vested directors' shares	85,909	77,119	84,911	76,339
	8,508,976	8,499,648	8,513,612	8,498,868
Dividends declared per share of common stock and paid in period	\$ 0.07	\$ 0.07	\$ 0.21	\$ 0.18

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PANHANDLE OIL AND GAS INC.  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY  
(Information at and for the nine months ended June 30, 2008 is unaudited)  
Nine Months Ended June 30, 2008

	Class A voting Common Stock Shares	Amount	Capital in Excess of Par Value	Deferred Directors Compensation	Retained Earnings	Treasury Shares	Treasury Stock	Total
Balances at September 30, 2007	8,431,502	\$ 140,524	\$ 2,146,071	\$ 1,358,778	\$ 50,035,998		\$	\$ 53,681,371
Net income					12,780,473			12,780,473
Dividends (\$ .21 per share)					(1,770,615)			(1,770,615)
Purchase of treasury stock						(54,514)	(1,955,761)	(1,955,761)
Increase in deferred directors compensation charged to expense				225,965				225,965
Balances at March 31, 2008	8,431,502	\$ 140,524	\$ 2,146,071	\$ 1,584,743	\$ 61,045,856	(54,514)	\$ (1,955,761)	\$ 62,961,433

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PANHANDLE OIL AND GAS INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

	Nine months ended June 30,	
	2008	2007
<b>Operating Activities</b>		
Net income	\$ 12,780,473	\$ 4,668,826
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion, amortization	13,376,346	10,504,001
Provision for impairment	385,672	2,027,866
Deferred income taxes	4,275,000	1,747,000
Lease bonus income		(42,019)
Exploration costs	397,125	943,489
Loss, net, on asset sales	83,986	51,818
Income of partnerships	(306,805)	(289,621)
Distributions received from partnerships	368,413	351,229
Directors' deferred compensation expense	225,965	133,820
Cash provided by changes in assets and liabilities:		
Oil and gas sales receivables	(9,359,047)	(2,032,209)
Other current assets	(819,020)	1,244,628
Accounts payable	130,477	(1,339,695)
Fair value of natural gas collar contracts	3,613,416	(446,581)
Accrued liabilities	322,991	51,172
Total adjustments	12,694,519	12,904,898
Net cash provided by operating activities	25,474,992	17,573,724
<b>Investing Activities</b>		
Capital expenditures, including dry hole costs	(27,757,275)	(17,052,261)
Proceeds from leasing of fee mineral acreage	131,449	174,338
Investments in partnerships		11,280
Proceeds from asset sales	181,120	510,378
Net cash used in investing activities	(27,444,706)	(16,356,265)
<b>Financing Activities</b>		
Borrowings under credit facility	40,058,723	8,984,560
Payments on credit facility	(34,701,332)	(8,621,300)
Purchase of treasury stock	(1,955,761)	
Payments of dividends	(1,770,615)	(1,516,055)
Net cash provided by (used in) financing activities	1,631,015	(1,152,795)
(Decrease) increase in cash and cash equivalents	(338,699)	64,664
Cash and cash equivalents at beginning of period	989,360	434,353

Cash and cash equivalents at end of period	\$ 650,661	\$ 499,017
<b>Supplemental Schedule of Noncash Investing and Financing Activities</b>		
Receivable from asset sales	\$ 658,668	\$
Additions and revisions, net, to asset retirement obligations	\$	\$ 197,697
Additions to properties and equipment included in accounts payable	\$ (1,868,432)	\$ (2,690,288)

(See accompanying notes)

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PANHANDLE OIL AND GAS INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

**NOTE 1: Accounting Principles and Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q as prescribed by the Securities and Exchange Commission, and include the Company's wholly owned subsidiary, Wood Oil Company (Wood). Management of Panhandle Oil and Gas Inc. (formerly Panhandle Royalty Company) believes that all adjustments necessary for a fair presentation of the consolidated financial position and results of operations for the periods have been included. All such adjustments are of a normal recurring nature. The consolidated results are not necessarily indicative of those to be expected for the full year. The Company's fiscal year runs from October 1 through September 30.

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 condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto included in the Company's 2007 Annual Report on Form 10-K.

**NOTE 2: Income Taxes**

The Company's provision for income taxes is reflective of excess percentage depletion, reducing the Company's effective tax rate from the federal statutory rate.

On October 1, 2007, the Company adopted the provisions of FIN No. 48, *Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109* (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 subsidiary 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 fiscal years prior to 2004.

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 included a review of the appropriate recognition threshold for each tax position recognized in the Company's financial statements. 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 General and administrative expense on its Consolidated Statements of Income. For the nine months ended June 30, 2008 and 2007, the Company recorded no interest or penalties on uncertain tax positions.

**NOTE 3: Stock Repurchase Program**

**ISSUER PURCHASES OF EQUITY SECURITIES**

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program
4/1 - 4/30/08	0	\$ 0.00	0	\$ 0
5/1 - 5/31/08	0	\$ 0.00	0	\$ 0

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6/1 - 6/30/08	54,514	\$ 35.88	54,514	\$ 44,239
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On May 28, 2008 the Company announced that its Board of Directors had approved a stock repurchase program to purchase up to \$2,000,000 of the Company's common stock. As of June 30, 2008, the Company had repurchased 54,514 shares at a total cost of \$1,955,761 under the program. The shares are to be held in treasury and are accounted for using the cost method.

NOTE 4: Earnings per Share

Earnings per share is calculated using net income divided by the weighted average number of voting common shares outstanding, including unissued, vested directors' shares during the period.

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**NOTE 5: Long-term Debt**

The Company has a revolving credit facility with Bank of Oklahoma (BOK) in the amount of \$50,000,000 which is subject to a semi-annual borrowing base determination. The current borrowing base is \$15,000,000. The facility matures on October 31, 2010. Borrowings under the facility are due at maturity. The facility bears interest at the national prime rate minus from 1.375% to .750%, or 30 day LIBOR plus from 1.375% to 2.000%. The interest rate charged will be based on the percent of the value advanced of the calculated loan value of Panhandle's oil and gas reserves. The interest rate spread from LIBOR or prime increases as a larger percent of the loan value of Panhandle's oil and gas properties is advanced. At June 30, 2008 the interest rate for the facility was 3.838%.

**NOTE 6: Dividends**

On May 21, 2008, the Company's Board of Directors approved payment of a \$.07 per share dividend that was paid on June 13, 2008 to shareholders of record on June 2, 2008.

**NOTE 7: Deferred Compensation Plan for Directors**

The Company has a deferred compensation plan for non-employee directors (the Plan). The Plan provides that each eligible director can individually elect to receive shares of Company stock rather than cash for board and committee chair retainers, board meeting fees and board committee meeting fees. These shares are unissued and vest as earned. The shares are credited to each director's deferred fee account at the closing market price of the stock on the date earned. Upon retirement, termination or death of the director or upon a change in control of the Company, the shares accrued under the Plan will be issued to the director.

**NOTE 8: Capitalized Costs**

Oil and gas properties include costs of \$177,029 on exploratory wells which were drilling and/or testing at June 30, 2008.

**NOTE 9: Derivatives**

The Company periodically utilizes certain derivative contracts, costless collars, to reduce its exposure to unfavorable changes in natural gas prices. Volumes under such contracts do not exceed expected production. The Company's collars contain a fixed floor price and a fixed ceiling price. If market prices exceed the ceiling price or fall below the floor, then the Company will receive the difference between the floor and market price or pay the difference between the ceiling and market price. If market prices are between the ceiling and the floor, then no payments or receipts related to the collars are required.

The Company accounts for its derivative contracts under Financial Accounting Standards Board Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended, (SFAS No. 133). Under the provision of SFAS No. 133, the Company is required to recognize all derivative instruments as either assets or liabilities in the consolidated balance sheet at fair value. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and resulting designation. For derivatives designated as cash flow hedges and meeting the effectiveness guidelines of SFAS No. 133, changes in fair value are recognized in other comprehensive income (loss) until the hedged item is recognized in earnings. Hedge effectiveness is required to be measured at least quarterly based on relative changes in fair value between the derivative contract and hedged item during the period of hedge designation. The ineffective portion of a derivative's change in fair value is recognized in current earnings. For derivative instruments not designated as hedging instruments, the change in fair value is recognized in earnings during the period of change as a change in derivative fair value.

Beginning in fiscal year 2007, the Company has entered in costless collar arrangements intended to reduce the Company's exposure to short-term fluctuations in the price of natural gas. Collar contracts set a minimum price, or floor and provide for payments to the Company if the basis adjusted price falls below the floor or require payments by the Company if the basis adjusted price rises above the ceiling. These arrangements cover only a portion of the Company's production and provide only partial price protection against declines in natural gas prices. These economic hedging arrangements may expose the Company to risk of financial loss and limit the benefit of future increases in prices. The derivative instruments will settle based on the prices below which are tied to indexes for certain pipelines in Oklahoma.

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Derivative contracts in place as of 6/30/08  
(prices below reflect the Company's net price from Oklahoma pipelines)

Contract period	Production volume covered per month	Floor price range (per mmbtu)	Ceiling price range (per mmbtu)
April - September, 2008	120,000 mmbtu	\$ 6.15 to \$6.40	\$ 8.05 to \$8.60
April - September, 2008	90,000 mmbtu	\$ 6.60 to \$6.85	\$ 7.50 to \$7.80
April - September, 2008	30,000 mmbtu	\$ 7.20 to \$7.45	\$ 8.15 to \$8.45
October - December, 2008	120,000 mmbtu	\$ 6.50 to \$6.90	\$ 8.75 to \$9.15

While the Company believes that its derivative contracts are effective in achieving the risk management objective for which they were intended, the Company has elected not to complete all of the documentation requirements necessary under SFAS No. 133 to permit these derivative contracts to be accounted for as cash flow hedges. The Company's fair value of derivative contracts was (\$3,506,500) as of June 30, 2008 and \$106,916 as of September 30, 2007. Realized and unrealized gains and losses for the periods ending June 30, 2008 and June 30, 2007 are scheduled below:

Gains (losses) on derivative contracts	Three months ended		Nine months ended	
	6/30/08	6/30/07	6/30/08	6/30/07
Realized	(\$878,900)	\$ 92,400	(\$777,900)	\$ 141,600
Unrealized	(\$1,407,889)	\$ 468,572	(\$3,613,416)	\$ 446,581
Total	(\$2,286,789)	\$ 560,972	(\$4,391,316)	\$ 588,181

**NOTE 10: Exploration Costs**

Certain non-producing leases which have expired or which have no future plans of development (aggregate carrying value of \$406,528) were fully impaired and charged to exploration costs in fiscal 2008, slightly offset by small credits on previously recorded exploratory dry holes. In fiscal 2007, \$493,776 was charged to exploration costs on one exploratory dry hole and \$440,627 was also charged to exploration costs on non-producing leases which had expired or which had no future plans of development.

**NOTE 11: Purchaser Bankruptcy**

The Company has a potential exposure from oil and natural gas sales for the months of June and July 2008 that its operators made to SemCrude, L.P. (SemCrude) and SemGas L.P. (SemGas), subsidiaries of SemGroup, L.P. (SemGroup). On July 21, 2008, SemGroup, including SemCrude and SemGas, filed a voluntary petition for reorganization under Chapter 11 of the Bankruptcy Code under Case Number 08-11525 (BLS) in the United States Bankruptcy Court for the District of Delaware.

As of June 30, 2008, the Company estimates that its operators (principally JMA Energy Company, LLC) had receivables, net to the Company's interest, of approximately \$325,000 from SemCrude and SemGas. Including sales of oil and natural gas production to SemCrude and SemGas during the period July 1 - 21, 2008, the Company estimates the current receivable balance, net to the Company's interest, to be approximately \$550,000. The Company's operators are pursuing various legal remedies to protect their interests. The Company is currently unable to quantify the amount of the receivable balance, if any, that is uncollectible. However, the Company believes that ultimate disposition of this

matter will not have a material adverse affect on its liquidity or overall financial position.

NOTE 12: New Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is still assessing the impact of this statement, but the adoption of this statement is not expected to have a material effect on the Company's financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This statement permits entities to choose to measure many financial instruments and certain other items at fair value. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of this statement is not expected to have a material effect on the Company's financial position, results of operations or cash flows.

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**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**FORWARD-LOOKING STATEMENTS AND RISK FACTORS**

Forward-Looking Statements for fiscal 2008 and later periods are made in this document. Such statements represent estimates by management based on the Company's historical operating trends, its proved oil and gas reserves and other information currently available to management. The Company cautions that the forward-looking statements provided herein are subject to all the risks and uncertainties incident to the acquisition, development and marketing of, and exploration for oil and gas reserves. These risks include, but are not limited to, oil and natural gas price risk, natural gas price hedging risk, drilling and equipment cost risk, field services cost risk, environmental risks, drilling risk, reserve quantity risk and operations and production risk. For all the above reasons, actual results may vary materially from the forward-looking statements and there is no assurance that the assumptions used are necessarily the most likely to occur.

**LIQUIDITY AND CAPITAL RESOURCES**

At June 30, 2008, the Company had positive working capital of \$11,499,758, as compared to positive working capital of \$7,191,111 at September 30, 2007. Increased working capital is the result of increases in oil and gas sales receivables partially offset by increases in the accrued liability on the fair value of derivative contracts and accounts payable. Oil and gas sales receivables increased as a result of increased oil and gas sales resulting from increases in oil and gas production and sales prices. The increase in oil and gas sales prices, both current and future, has also caused the increase in the accrued liability on the fair value of derivative contracts. Accounts payable increased as the Company continues capital spending for oil and gas activities at a high level.

Operating cash flow remains strong. Additions to properties and equipment for oil and gas activities for the 2008 nine-month period amounted to \$29,625,707. Management currently expects additions to properties and equipment for oil and gas activities of approximately \$42,000,000 for fiscal 2008. Management's strategy to participate with larger working interests in new wells combined with high drilling activity has resulted in continued increases in capital expenditures. Drilling in the Woodford Shale and Fayetteville Shale unconventional resource plays in southeast Oklahoma and Arkansas, respectively, and in the Dill City play in western Oklahoma will continue to be a large component of expected capital additions for the next several years. As drilling activity remains high, costs for drilling rigs, well equipment and services remain high, and are expected to remain so for the remainder of fiscal 2008 and into fiscal 2009. Any acquisitions of oil and gas properties would further increase the capital addition amount.

The Company funds capital additions, overhead costs, stock repurchases and dividend payments primarily from operating cash flow. However, due primarily to the sharp increase in Company drilling activity, the Company also utilizes its revolving line-of-credit facility to help fund these expenditures. Further increases in the Company's drilling activity will likely result in increased borrowings under the Company's credit facility. With the uncertainty of natural gas prices, and their effect on cash flow, some amounts have been and will be in the next several quarters borrowed under the Company's credit facility. However, the Company has entered into natural gas collar contracts (discussed in Note 9 above) to help guard against potential negative price fluctuations which would reduce available capital. The Company has substantial availability under its bank debt facility and the availability could be increased, if needed.

**RESULTS OF OPERATIONS**

**THREE MONTHS ENDED JUNE 30, 2008 COMPARED TO THREE MONTHS ENDED JUNE 30, 2007**

**Overview:**

The Company recorded a third quarter 2008 net income of \$6,468,885, or \$.76 per share, as compared to a net income of \$2,904,078 or \$.34 per share in the 2007 quarter.



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Total revenues increased \$7,464,860 or 68% for the 2008 quarter. The increase was the result of a \$10,370,364 increase in oil and gas sales resulting from a 44% increase in gas sales volumes, a 41% increase in gas sales price, a 2% increase in oil sales volumes and a 95% increase in oil sales price. Losses on natural gas collar contracts resulted in a revenue decrease of \$2,847,761. The table below outlines the Company's production and average sales prices for oil and natural gas for the three month periods of fiscal 2008 and 2007:

	BARRELS SOLD	AVERAGE PRICE	MCF SOLD	AVERAGE PRICE	MCFE SOLD
Three months ended 6/30/08	31,907	\$ 120.92	1,788,462	\$ 9.33	1,979,904
Three months ended 6/30/07	31,223	\$ 62.15	1,244,685	\$ 6.62	1,432,023

The Company's applied strategy of increasing its working interests in new wells drilled combined with increased drilling activity and the associated increase in drilling expenditures continues to result in increased production volumes for both gas and oil, as compared to the fiscal 2007 quarter. Increased production is principally attributable to increased production from the western Oklahoma Dill City area (gas and oil), southeast Oklahoma Woodford Shale area (gas only), the Fayetteville Shale area in Arkansas (gas only) and the Yellowstone Southeast field (oil only) in Woods County, Oklahoma. The Company's drilling continues to be concentrated on gas production, although the Dill City area and the Yellowstone Southeast field have yielded oil production that is significant to the Company. New wells coming on line are continuing to replace the decline in production of older wells, and the Company anticipates additional new production coming on line in future periods.

Production for the last five quarters was as follows:

Quarter ended	Barrels		
	Sold	MCF Sold	MCFE
6/30/08	31,907	1,788,462	1,979,904
3/31/08	32,399	1,533,363	1,727,757
12/31/07	36,721	1,610,880	1,831,206
9/30/07	31,677	1,529,924	1,719,986
6/30/07	31,223	1,244,685	1,432,023

**Losses on Natural Gas Collar Contracts:**

The Company's fair value of derivative contracts was (\$3,506,500) as of June 30, 2008 and (\$2,098,611) as of March 31, 2008, resulting in a loss of \$2,286,789 (including \$878,900 of realized losses) in the three months ended June 30, 2008 compared to a gain of \$560,972 for the three months ended June 30, 2007. The Company made cash payments under the contracts of \$878,900 for the three months ended June 30, 2008 and received cash payments of \$92,400 for the three months ended June 30, 2007.

**Lease Operating Expenses (LOE):**

LOE increased \$1,290,683 or 145% in the 2008 quarter to \$1.10 per mcf, as compared to \$.62 per mcf in the 2007 quarter. The \$.48 per mcf increase is due to sharp increases in charges for transportation, compression, dehydration, gathering systems and fuel gas related to treating natural gas produced and delivering it to market. The Company is experiencing these higher operating costs on wells located particularly in the southeast Oklahoma Woodford Shale and the western Oklahoma Dill City areas. LOE costs for other than the treating and delivery to market of natural gas produced increased approximately \$251,000 in the 2008 quarter as compared to the 2007 quarter, mostly a result of new wells put on production.

**Production Taxes:**

Production taxes decreased \$46,721 or 7% in the 2008 quarter. The decline in production tax expense is the result of production tax credits of approximately \$283,000 on horizontal wells drilled in the southeast Oklahoma Woodford Shale. The state of Oklahoma offers a refund on horizontally drilled wells of nearly all production taxes paid for the first four years of production or until well payout occurs, whichever comes first. The decrease also relates to the increasing number of Arkansas Fayetteville Shale wells coming on line as compared to a year ago which carry an

extremely low production tax rate of only \$.012 per mcf produced. The combined result is a decrease in the severance tax rate as a percentage of oil and gas sales from 7.1% in the 2007 quarter to 3.3% in the 2008 quarter.

Exploration Costs:

These costs decreased \$188,684 in the 2008 quarter. Leasehold expiration and abandonment costs were \$35,399 for the 2008 quarter as compared to \$216,776 for the 2007 quarter. There were no exploratory dry holes drilled in either the 2008 or the 2007 quarter.

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**Table of Contents****Depreciation, Depletion and Amortization (DD&A):**

DD&A increased \$1,027,131 or 28% in the 2008 quarter. DD&A in the 2008 quarter was \$2.36 per mcfe as compared to \$2.54 per mcfe in the 2007 quarter. The overall increase is the result of increased production volumes in the 2008 quarter over the 2007 quarter. The decrease in the DD&A rate per mcfe is due to higher than normal DD&A per mcfe in the 2007 quarter as a result of downward reserve revisions on approximately fifty of the Company's working interest wells in 2007, resulting in significant additional DD&A charges on those wells totaling approximately \$500,000.

**Provision for Impairment:**

The provision for impairment decreased \$360,367 in the 2008 quarter. In the 2008 quarter one smaller field was impaired \$37,666 as compared to the 2007 quarter in which impairment on two fields totaled \$398,033.

**General and Administrative Costs (G&A):**

G&A costs increased \$251,666 or 28% in the 2008 quarter principally due to increased personnel related costs of approximately \$141,000 and increased stock exchange and other fees of approximately \$68,000.

**Income Taxes:**

The provision for income taxes for the 2008 quarter increased \$1,745,500 due to an increase in income before provision for income taxes of \$5,310,307 in the 2008 quarter as compared to the 2007 quarter. The effective tax rate in the 2008 quarter was 32%. The Company utilizes excess percentage depletion to reduce its effective tax rate from the federal statutory rate.

**NINE MONTHS ENDED JUNE 30, 2008 COMPARED TO NINE MONTHS ENDED JUNE 30, 2007****Overview:**

The Company recorded a nine month period 2008 net income of \$12,780,473, or \$1.50 per share, as compared to a net income of \$4,668,826 or \$.55 per share in the 2007 period.

**Revenues:**

Total revenues increased \$16,840,257 or 60% for the 2008 period. The increase was primarily the result of a \$21,969,473 increase in oil and gas sales offset by a decrease in the value of natural gas collar contracts of \$4,979,497. The oil and gas sales increase resulted from a 36% increase in gas sales volumes, a 27% increase in gas sales price, a 34% increase in oil sales volumes and a 71% increase in oil sales price for the 2008 quarter. The decrease in the value of natural gas collar contracts is the result of losses incurred during the 2008 period of \$4,391,316 as compared to gains during the 2007 period of \$588,181. The table below outlines the Company's production and average sales prices for oil and natural gas for the nine month periods of fiscal 2008 and 2007:

	BARRELS SOLD	AVERAGE PRICE	MCF SOLD	AVERAGE PRICE	MCFE SOLD
Nine months ended 6/30/08	101,027	\$ 100.12	4,932,704	\$ 7.82	5,538,866
Nine months ended 6/30/07	75,667	\$ 58.72	3,617,419	\$ 6.16	4,071,421

As the Company continues increasing its drilling activities and increasing its working interests in new wells drilled, expectations are continuing increases in production volumes of natural gas in fiscal 2008 as compared to fiscal 2007. New drilling continues to be concentrated on gas production; however, the drilling and completion of wells targeting oil production and several gas wells with associated oil production has recently increased. During the last year, new wells coming on line have more than replaced the decline in production of older wells. The Company expects to continue to have additional production come on line in future periods.

**Losses on Natural Gas Collar Contracts:**

The Company's fair value of derivative contracts was (\$3,506,500) as of June 30, 2008 and \$106,916 as of September 30, 2007, resulting in a loss of \$4,391,316 (including \$777,900 of realized losses) in the nine months ended June 30, 2008 compared to a gain of \$588,181 for the nine months ended June 30, 2007. The Company made cash payments of \$777,900 (realized losses) for the 2008 period and received cash payments of \$141,600 (realized gains) in the 2007 period.

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### **Lease Operating Expenses (LOE):**

LOE increased \$2,355,543 or 90% in the 2008 period to \$.90 per mcf, as compared to \$.64 per mcf in the 2007 period. The per mcf increase is due to sharp increases in charges for transportation, compression, dehydration, gathering systems and fuel gas related to treating natural gas produced and delivering it to market. The Company is experiencing these higher operating costs on wells located particularly in the southeast Oklahoma Woodford Shale and the western Oklahoma Dill City areas. LOE costs for other than the treating and delivery to market of natural gas produced increased approximately \$554,000 in the 2008 period compared to the 2007 period, mostly a result of new wells put on production.

### **Production Taxes:**

Production taxes increased \$667,001 or 38% in the 2008 period. The increase in production tax expense is the result of increased oil and gas sales as production taxes are largely paid as a percentage of oil and gas sales. Production taxes as a percentage of oil and gas sales for the 2008 period are 5.0% as compared to 6.6% for the 2007 period. This decrease is attributable to production tax credits of approximately \$283,000 on horizontal wells drilled in the southeast Oklahoma Woodford Shale. The state of Oklahoma offers a refund on horizontally drilled wells of nearly all production taxes paid for the first four years of production or until well payout occurs, whichever comes first. The decrease also relates to the increasing number of Arkansas Fayetteville Shale wells coming on line as compared to a year ago which carry an extremely low production tax rate of only \$.012 per mcf produced.

### **Exploration Costs:**

These costs decreased \$546,364 in the 2008 period. This decrease is principally the result of one exploratory dry hole drilled in the 2007 period in the Mystic Bayou prospect in Louisiana. There were no dry holes in the 2008 period.

### **Depreciation, Depletion and Amortization (DD&A):**

DD&A increased \$2,872,345 or 27% in the 2008 period. DD&A was \$2.41 per mcf in the 2008 period as compared to \$2.58 per mcf in the 2007 period. The overall increase is the result of increased production volumes in the 2008 period over the 2007 period. The decrease in the DD&A rate per mcf is due to higher than normal DD&A per mcf in 2007 as a result of downward reserve revisions on approximately fifty of the Company's working interest wells resulting in significant additional DD&A charges on those wells totaling approximately \$2,000,000.

### **Provision for Impairment:**

The provision for impairment decreased \$1,642,194 in the 2008 period. In the 2008 period six fields were impaired \$379,147 as compared to the 2007 period in which impairment on eight fields totaled \$1,967,955. In the 2007 period approximately \$1,300,000 of the impairment provision related to one field in western Oklahoma. Declining production caused lower reserve estimates which then resulted in significant impairment of the field. The 2007 period also included impairment of one New Mexico field of approximately \$390,000.

### **General and Administrative Costs (G&A):**

G&A costs increased \$935,775 or 31% in the 2008 period. The increase is primarily due to increased personnel costs of approximately \$634,000, increased director fees of \$91,000, increased stock exchange and other fees of approximately \$61,000 and increased professional fees of approximately \$59,000.

### **Income Taxes:**

The 2008 period provision for income taxes increased \$4,203,707 due to increased income before provision for income taxes of \$12,315,354. The effective tax rate was 33% for the 2008 period and 31% for the 2007 period. The Company utilizes excess percentage depletion to reduce its effective tax rate from the federal statutory rate.

## **CRITICAL ACCOUNTING POLICIES**

Preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. However, the accounting principles used by the Company generally do not change the Company's reported cash flows or liquidity. Generally, accounting rules do not involve a selection among alternatives, but involve a selection of the appropriate policies for applying the basic principles. Interpretation of the existing rules must be done and judgments made on how the specifics of a given rule apply to the Company.



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The more significant reporting areas impacted by management's judgments and estimates are crude oil and natural gas reserve estimation, impairment of assets, oil and gas sales revenue accruals and provision for income tax. Management's judgments and estimates in these areas are based on information available from both internal and external sources, including engineers, geologists, consultants and historical experience in similar matters. Actual results could differ from the estimates as additional information becomes known. The oil and gas sales revenue accrual is particularly subject to estimates due to the Company's status as a non-operator on all of its properties. Production information obtained from well operators is substantially delayed. This causes the estimation of recent production, used in the oil and gas revenue accrual, to be subject to some variations.

### **Oil and Gas Reserves**

Management considers the estimation of crude oil and natural gas reserves to be the most significant of its judgments and estimates. These estimates affect the unaudited standardized measure disclosures, as well as DD&A and impairment calculations. Changes in crude oil and natural gas reserve estimates affect the Company's calculation of depreciation, depletion and amortization, provision for abandonment and assessment of the need for asset impairments. On an annual basis, with a semi-annual update, the Company's consulting engineer, with assistance from Company geologists, prepares estimates of crude oil and natural gas reserves based on available geologic and seismic data, reservoir pressure data, core analysis reports, well logs, analogous reservoir performance history, production data and other available sources of engineering, geological and geophysical information. As required by the guidelines and definitions established by the SEC, these estimates are based on current crude oil and natural gas pricing. Crude oil and natural gas prices are volatile and largely affected by worldwide production and consumption and are outside the control of management. Projected future crude oil and natural gas pricing assumptions are used by management to prepare estimates of crude oil and natural gas reserves used in formulating management's overall operating decisions in the exploration and production segment.

### **Successful Efforts Method of Accounting**

The Company has elected to utilize the successful efforts method of accounting for its oil and gas exploration and development activities. Exploration expenses, including geological and geophysical costs, rentals and exploratory dry holes, are charged against income as incurred. Costs of successful wells and related production equipment and developmental dry holes are capitalized and amortized by property using the unit-of-production method as oil and gas is produced. This accounting method may yield significantly different operating results than the full cost method.

### **Impairment of Assets**

All long-lived assets, principally oil and gas properties, are monitored for potential impairment when circumstances indicate that the carrying value of the asset may be greater than its estimated future net cash flows. The evaluations involve significant judgment since the results are based on estimated future events, such as inflation rates, future sales prices for oil and gas, future production costs, estimates of future oil and gas reserves to be recovered and the timing thereof, the economic and regulatory climates and other factors. The need to test a property for impairment may result from significant declines in sales prices or unfavorable adjustments to oil and gas reserves. Any assets held for sale are reviewed for impairment when the Company approves the plan to sell. Estimates of anticipated sales prices are highly judgmental and subject to material revision in future periods. Because of the uncertainty inherent in these factors, the Company cannot predict when or if future impairment charges will be recorded.

### **Oil and Gas Sales Revenue Accrual**

The Company does not operate any of its oil and gas properties. Drilling in the last two years has resulted in adding numerous wells with significantly larger interests, thus increasing the Company's production and revenue. On many of these wells the most current available production data is gathered from the appropriate operators and oil and gas index prices local to each well are used to more accurately estimate the accrual of revenue on these wells. Timely obtaining production data on all other wells from the operators is not feasible; therefore, the Company utilizes past production receipts and estimated sales price information to estimate its accrual of revenue on all other wells each quarter. The oil and gas sales revenue accrual can be impacted by many variables including rapid production decline rates, production curtailments by operators, the shut-in of wells with mechanical problems and rapidly changing market prices for oil and natural gas. These variables could lead to an over or under accrual of oil and gas sales at the end of any particular quarter. Based on past history, the Company's estimated accrual has been materially accurate.

Income Taxes

The estimation of the amounts of income tax to be recorded by the Company involves interpretation of complex tax laws and regulations as well as the completion of complex calculations, including the determination of the Company's

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percentage depletion deduction. Although the Company's management believes its tax accruals are adequate, differences may occur in the future depending on the resolution of pending and new tax matters.

The above description of the Company's critical accounting policies is not intended to be an all-inclusive discussion of the uncertainties considered and estimates made by management in applying accounting principles and policies. Results may vary significantly if different policies were used or required and if new or different information becomes known to management.

### **ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company's results of operations and operating cash flows can be significantly impacted by changes in market prices for oil and gas. Based on the Company's 2007 production, a \$.10 per mcf change in the price received for natural gas production would result in a corresponding \$515,000 annual change in pre-tax operating cash flow. A \$1.00 per barrel change in the price received for oil production would result in a corresponding \$107,000 annual change in pre-tax operating cash flow. Cash flows could also be impacted, to a lesser extent, by changes in the market interest rates related to the revolving credit facility which bears interest at an annual variable interest rate equal to the national prime rate minus from 1.375% to .750% or 30 day LIBOR plus from 1.375% to 2.000%. At June 30, 2008, the Company had \$10,018,862 outstanding under this facility. Based on total debt outstanding at June 30, 2008 a .5% change in interest rates would result in a \$50,100 annual change in pre-tax operating cash flow.

The Company periodically utilizes certain derivative contracts, costless collars, to reduce its exposure to unfavorable changes in natural gas prices. Volumes under such contracts do not exceed expected production. The Company's collars contain a fixed floor price and a fixed ceiling price. If market prices exceed the ceiling price or fall below the floor, then the Company will receive the difference between the floor and market price or pay the difference between the ceiling and market price. If market prices are between the ceiling and the floor, then no payments or receipts related to the collars are required. The Company had not, through fiscal 2006, entered into derivative instruments to hedge the price risk on its oil or gas production. Beginning in fiscal year 2007, the Company has entered in costless collar arrangements intended to reduce the Company's exposure to short-term fluctuations in the price of natural gas. Collar contracts set a minimum price, or floor and provide for payments to the Company if the basis adjusted price falls below the floor or require payments by the Company if the basis adjusted price rises above the ceiling. These arrangements cover only a portion of the Company's production and provide only partial price protection against declines in natural gas prices. These economic hedging arrangements may expose the Company to risk of financial loss and limit the benefit of future increases in prices.

### **ITEM 4 CONTROLS AND PROCEDURES**

The Company maintains disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, that are designed to ensure that information required to be disclosed in reports the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is collected and communicated to management, including the Company's President/Chief Executive Officer and Vice President/Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating its disclosure controls and procedures, management recognized that no matter how well conceived and operated, disclosure controls and procedures can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. The Company's disclosure controls and procedures have been designed to meet, and management believes that they do meet, reasonable assurance standards. Based on their evaluation as of the end of the fiscal period covered by this report, the Chief Executive Officer and Chief Financial Officer have concluded that, subject to the limitations noted above, the Company's disclosure controls and procedures were effective to ensure that material information relating to the Company, including its consolidated subsidiary, is made known to them. There were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting made during the fiscal quarter or subsequent to the date the assessment was completed.

## **PART II OTHER INFORMATION**

### **ITEM 6 EXHIBITS**



(a) EXHIBITS	Exhibit 31.1 and 31.2	Certification under Section 302 of the Sarbanes-Oxley Act of 2002
	Exhibit 32.1 and 32.2	Certification under Section 906 of the Sarbanes-Oxley Act of 2002
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SIGNATURES

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

PANHANDLE OIL AND GAS INC.

August 6, 2008

Date

/s/ Michael C. Coffman

Michael C. Coffman, President and  
Chief Executive Officer

August 6, 2008

Date

/s/ Lonnie J. Lowry

Lonnie J. Lowry, Vice President  
and Chief Financial Officer

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