

ARENA RESOURCES INC
Form 10-Q
November 01, 2005

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

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2005

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

FOR THE TRANSITION PERIOD From _____ to _____.

Commission File Number 001-31657

ARENA RESOURCES, INC.

(Exact name of registrant as specified in its charter)

Nevada

(State or other jurisdiction of Incorporation or organization)

73-1596109

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

4920 South Lewis Street, Suite 107

Tulsa, Oklahoma 74105

(Address of principal executive offices)

(918) 747-6060

(Issuer's telephone number)

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 past 12 months, and (2) has been subject to such filing requirements for the past 90 days.

X Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act):

Yes X No

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

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

As of October 21, 2005, the Company had outstanding 13,062,452 shares of common stock (\$0.001 par value).

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Arena Resources, Inc.

For the Quarter Ended September 30, 2005

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Part I - Financial Information

Item 1.

Financial Statements:

The condensed financial statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading.

In the opinion of the Company, all adjustments, consisting of only normal recurring adjustments, necessary to present fairly the financial position of the Company and the results of its operations and its cash flows have been made. The results of its operations and its cash flows for the three and nine months ended September 30, 2005 are not necessarily indicative of the results to be expected for the year ending December 31, 2005.

ARENA RESOURCES, INC.
CONDENSED BALANCE SHEETS
(UNAUDITED)

	September 30, 2005	December 31, 2004
ASSETS		
Current Assets		
Cash	\$ 6,571,237	\$ 1,253,969
Accounts receivable	2,902,136	1,149,513
Joint interest billing receivable	28,727	61,805
Prepaid expenses	33,136	33,136
Total Current Assets	9,535,236	2,498,423
Property and Equipment, Using Full Cost Accounting		
Oil and gas properties subject to amortization	53,709,589	34,421,920
Drilling advances	-	900,000
Equipment	26,687	26,687
Office equipment	102,275	60,401
Total Property and Equipment	53,838,551	35,409,008
Less: Accumulated depreciation and amortization	(3,115,915)	(1,565,124)
Net Property and Equipment	50,722,636	33,843,884
Total Assets	\$ 60,257,872	\$ 36,342,307
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	\$ 1,446,884	\$ 1,805,865
Accrued liabilities	171,855	34,800
Total Current Liabilities	1,618,739	1,840,665
Long-Term Liabilities		
Notes payable	-	10,000,000
Notes payable to related parties	400,000	400,000
Put option	8,536	95,033
Asset retirement liability	1,370,567	1,267,993
Deferred income taxes	5,885,332	2,129,993
Total Long-Term Liabilities	7,664,435	13,893,019
Stockholders' Equity		
Preferred stock - \$0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding	-	-
Common stock - \$0.001 par value; 100,000,000 shares authorized; 12,502,827 shares and 9,132,910 shares outstanding, respectively	12,503	9,133
Additional paid-in capital	40,838,575	15,223,135

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Options and warrants outstanding	794,991	2,553,159
Retained earnings	9,328,629	2,823,196
Total Stockholders' Equity	50,974,698	20,608,623
Total Liabilities and Stockholders' Equity	\$ 60,257,872	\$ 36,342,307

See the accompanying notes to unaudited condensed financial statements.

ARENA RESOURCES, INC.
CONDENSED STATEMENTS OF OPERATIONS
(UNAUDITED)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2004	2005	2004
Oil and Gas Revenues	\$ 7,937,785	\$ 2,516,970	\$ 16,481,074	\$ 5,509,784
Costs and Operating Expenses				
Oil and gas production costs	946,380	564,933	2,384,816	1,284,753
Oil and gas production taxes	569,330	192,535	1,230,444	404,268
Depreciation, depletion and amortization	645,908	237,212	1,550,791	553,038
General and administrative expense	259,978	131,619	803,082	473,391
Total Costs and Operating Expenses	2,421,596	1,126,299	5,969,133	2,715,450
Other Income (Expense)				
Gain from change in fair value of put options	20,627	-	86,497	2,905
Accretion expense	(25,158)	(13,007)	(74,484)	(38,072)
Interest expense	(19,266)	(60,296)	(189,541)	(128,407)
Net Other Income (Expense)	(23,797)	(73,303)	(177,528)	(163,574)
Income Before Provision for Income Taxes	5,492,392	1,317,368	10,334,413	2,630,760
Provision for Deferred Income Taxes	(2,032,185)	(487,319)	(3,828,980)	(942,521)
Net Income	\$ 3,460,207	\$ 830,049	\$ 6,505,433	\$ 1,688,239
Basic Net Income Per Common Share				
	0.30	0.10	0.62	0.23
Diluted Net Income Per Common Share				
	0.27	0.09	0.54	0.20

See the accompanying notes to unaudited condensed financial statements.

ARENA RESOURCES, INC.
CONDENSED STATEMENTS OF CASH FLOWS
(UNAUDITED)

<i>For the Nine Months Ended September 30,</i>	2005	2004
Cash Flows From Operating Activities		
Net income	\$ 6,505,433	\$ 1,688,239
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion and amortization	1,550,791	553,038
Provision for income taxes	3,828,980	942,521
Gain from change in fair value of put option	(86,497)	(2,905)
Loss on sale of equipment	-	5,585
Accretion of discounted liabilities	74,484	38,073
Changes in assets and liabilities:		
Accounts and joint interest receivable	(1,719,545)	(295,218)
Prepaid expenses	-	(4,201)
Accounts payable and accrued liabilities	(295,567)	488,985
Net Cash Provided by Operating Activities	9,858,079	3,414,117
Cash Flows from Investing Activities		
Proceeds from sale of equipment	-	10,500
Cash payments on purchase of East Hobbs	-	(1,028,000)
Purchase and development of oil and gas properties	(18,021,414)	(1,231,668)
Maturity of long term investment	-	25,234
Purchase of office equipment	(41,874)	(18,035)
Net Cash Used in Investing Activities	(18,063,288)	(2,241,969)
Cash Flows From Financing Activities		
Proceeds from issuance of common stock and warrants, net of offering costs	9,916,749	8,434,823
Proceeds from exercise of warrants	13,605,728	189,500
Issuance of notes payable	-	1,000,000
Payment of notes payable	(10,000,000)	(10,008,440)
Net Cash Provided by (Used in) Financing Activities	13,522,477	(384,117)
Net Increase in Cash	5,317,268	788,031
Cash at Beginning of Period	1,253,969	1,076,676
Cash at End of Period	\$ 6,571,237	\$ 1,864,707
Supplemental Cash Flow Information		
Cash paid for income taxes	\$ 73,641	\$ -
Cash paid for interest	\$ 189,541	\$ 131,421

Non-Cash Investing and Financing Activities

Common stock issued for properties	\$	340,650	\$	-
Asset retirement obligation incurred in property acquisition		28,090		-
East Hobbs property was acquired as follows:				
Fair value of assets acquired			\$	10,295,312
Liabilities assumed		-		(54,319)
Notes payable incurred		-		(9,008,440)
Common stock issued		-		(204,553)
Cash paid	\$		\$	1,028,000

See the accompanying notes to unaudited condensed financial statements.

ARENA RESOURCES, INC.
NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS
SEPTEMBER 30, 2005

NOTE 1 - BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Condensed Financial Statements - The accompanying condensed financial statements have been prepared by the Company and are unaudited. In the opinion of management, the accompanying unaudited financial statements contain all adjustments necessary for fair presentation, consisting of normal recurring adjustments, except as disclosed herein.

The accompanying unaudited interim financial statements have been condensed pursuant to the rules and regulations of the Securities and Exchange Commission; therefore, certain information and disclosures generally included in financial statements have been condensed or omitted. The condensed financial statements should be read in conjunction with the Company's annual financial statements included in its annual report on Form 10-KSB as of December 31, 2004. The financial position and results of operations for the three and nine months ended September 30, 2005 are not necessarily indicative of the results to be expected for the full year ending December 31, 2005.

Nature of Operations - The Company owns interests in oil and gas properties located in Oklahoma, Texas, Kansas and New Mexico. The Company is engaged primarily in the acquisition, exploration and development of oil and gas properties and the production and sale of oil and gas.

Use of Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Oil and Gas Properties - The Company uses the full cost method of accounting for oil and gas properties. Under this method, all costs associated with acquisition, exploration, and development of oil and gas reserves are capitalized. Costs capitalized include acquisition costs, geological and geophysical expenditures, lease rentals on undeveloped properties and costs of drilling and equipping productive and non-productive wells. Drilling costs include directly related overhead costs. Capitalized costs are categorized either as being subject to amortization or not subject to amortization.

All capitalized costs of oil and gas properties, including the estimated future costs to develop proved reserves and estimated future costs of abandonment and site restoration, are amortized on the unit-of-production method using estimates of proved reserves as determined by independent engineers. Investments in unproved properties and major development projects are not amortized until proved reserves associated with the projects can be determined. The Company evaluates oil and gas properties for impairment at least quarterly. Amortization expense for the nine months ended September 30, 2005 was \$1,550,791 based on depletion at the rate of \$4.52 per barrel of oil equivalent compared to \$553,038 based on depletion at the rate of \$3.64 per barrel of oil equivalent for the nine months ended September 30, 2004. These amounts include \$13,936 and \$8,628 of depreciation on equipment during the nine months ended September 30, 2005 and 2004, respectively.

In addition, capitalized costs are subject to a ceiling test which limits such costs to the estimated present value of future net revenues from proved reserves, discounted at a 10-percent interest rate, based on current economic and operating conditions, plus the lower of cost or fair market value of unproved properties. Consideration received from sales or transfers of oil and gas property is accounted for as a reduction of capitalized costs. Revenue is not recognized in connection with contractual services performed in connection with properties in which the Company holds an ownership interest.

ARENA RESOURCES, INC.
NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS
SEPTEMBER 30, 2005

Income Per Common Share - Basic income per common share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted income per share reflects the potential dilution that could occur if all contracts to issue common stock were converted into common stock, except for those that are anti-dilutive.

Concentration of Credit Risk and Major Customer - The Company currently has cash in excess of federally insured limits at September 30, 2005. During the nine months ended September 30, 2005, sales to two customers represented 70% and 14%, respectively. At September 30, 2005, these two customers made up 80% and 9% of accounts receivable, respectively.

Stock-Based Employee Compensation - The Company applies the recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) and related interpretations in accounting for its stock-based compensation awards to employees. Under APB 25, no stock-based compensation expense was charged to earnings, as all options granted had an exercise price equal to or greater than the adjusted fair value of the underlying common stock on the grant date.

Alternately, Statement on Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), allows companies to recognize compensation expense over the related service period based on the grant date fair value of the stock option awards. The following table illustrates the effect on net income and basic and diluted income per common share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income, as reported	\$ 3,460,207	\$ 830,049	\$ 6,505,433	\$ 1,688,239
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(124,385)	(71,435)	(402,819)	(273,632)
Pro Forma Net Income	\$ 3,335,822	\$ 758,614	\$ 6,102,614	\$ 1,414,607
Income per Common Share				
Basic, as reported	\$ 0.30	\$ 0.10	\$ 0.62	\$ 0.23
Basic, pro forma	0.29	0.09	0.58	0.19
Diluted, as reported	0.27	0.09	0.54	0.20
Diluted, pro forma	0.26	0.09	0.51	0.17

ARENA RESOURCES, INC.
NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS
SEPTEMBER 30, 2005

NOTE 2 - EARNINGS PER SHARE INFORMATION

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2004	2005	2004
Net Income	\$ 3,460,207	\$ 830,049	\$ 6,505,433	\$ 1,688,239
Basic Weighted-Average Common Shares Outstanding	11,491,994	8,164,434	10,554,879	7,500,852
Effect of dilutive securities				
Warrants	967,985	447,204	984,055	510,327
Stock options	522,273	268,646	522,273	290,659
Diluted Weighted-Average Common Shares Outstanding	12,982,252	8,880,284	12,061,207	8,301,838
Basic Income Per Common Share				
Net income	0.30	0.10	0.62	0.23
Diluted Income Per Common Share				
Net Income	0.27	0.09	0.54	0.20

NOTE 3 - ACQUISITION OF OIL AND GAS PROPERTIES

On March 24, 2005, the Company entered into a definitive agreement to acquire approximately 18,000 acres in Hamilton and Greeley counties, Kansas. On March 16, 2005, the Company issued 20,000 shares, valued at \$261,600 or \$13.08 per share, of restricted common stock as partial payment for this acquisition. The Company has also paid cash in the amount of \$266,380 for the acquisition.

On July 28, 2005, the Company closed the acquisition of working interest ownership in the Parrish properties located in Andrews County, Texas. The interests in the leases acquired range from an 20.20% to 100% working interest, 16.13% to 79.20% net revenue interest. Although the Purchase and Sales Agreement transferred the revenue and the related operating costs from Parrish properties to Arena beginning June 1, 2005, Arena did not control the property interests until July 28, 2005. As a result, the acquisition date for accounting purposes was July 28, 2005 and the Parrish properties operations have been included in the results of operations of Arena from July 28, 2005. Revenues and operating costs for the months of June and July will be treated as adjustments to the purchase price. The Company paid \$1,200,000 to the sellers on July 28, 2005. In addition the Company issued 5,000 shares of common stock valued at \$79,050, or \$15.81 per share, as a finders' fee on the Parrish properties acquisition.

On May 7, 2004, the Company acquired an 82.24% working interest, 67.60% net revenue interest, in the East Hobbs San Andres Property mineral lease ("East Hobbs") located in Lea County, New Mexico. Although the Purchase and Sales Agreement transferred the revenue and the related operating costs from East Hobbs to Arena beginning March 1, 2004, Arena did not control the property interests until May 7, 2004. As a result, the acquisition date for accounting purposes was May 7, 2004 and the East Hobbs' operations have been included in the results of operations of Arena from May 7, 2004. Revenues and operating costs for the months of March and April were treated as adjustments to the purchase price.

At the date of acquisition, East Hobbs was comprised of 21 operating oil and gas wells that were unitized into one lease prior to the acquisition. The Company purchased East Hobbs for its current production and cash flow, as well as for the drilling and secondary recovery opportunities from the property. The Company paid \$10,008,440 to the sellers, including \$9,008,440 paid directly from borrowings under a credit facility and a bridge financing from a bank described more fully in Note 4. In addition, the Company paid acquisition costs of \$28,000 and issued 40,000 shares of common stock valued at \$204,553, or \$5.11 per share, as a finder's fee on the East Hobbs San Andres Property acquisition.

ARENA RESOURCES, INC.
NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS
SEPTEMBER 30, 2005

On November 18, 2004, Arena Resources, Inc. entered into a binding letter of intent to acquire 100% of the working interest, 75% of the net revenue interest, of the Fuhrman-Mascho Property mineral leases under the terms of Asset Purchase Agreements (the "Agreements"). Under the terms of the Agreements, the sellers transferred effective control of the property to the Company on December 1, 2004 without restrictions. Accordingly, the acquisition date was December 1, 2004. The results of operations of the Fuhrman-Mascho property have been included in the results of operations of the Company from December 1, 2004.

At the date of acquisition, Fuhrman-Mascho property consisted of 84 leases with a total of 174 operating oil and gas wells. The Company purchased Fuhrman-Mascho for its current production and cash flow, as well as for the drilling and development opportunities from the property. On December 20, 2004, the Company made cash payments to the sellers of \$9,667,381, issued the sellers 149,658 shares of common stock valued at \$1,050,091 or \$7.00 per share based on the market value of the common stock over the 2-day period before and after November 18, 2004, issued the sellers put options entitling the sellers to demand that the Company reacquire the 149,658 shares of common stock at \$7.00 per share from November 1, 2006 through November 30, 2006, and received call options from the sellers entitling the Company to reacquire the 149,658 shares of common stock at \$8.50 per share from the date issued through November 1, 2006. In addition, the Company paid acquisition costs of \$44,421 and issued 30,000 shares of common stock as a consulting and finder's fee, valued at \$210,000, or \$7.00 per share. The consideration paid or issued on December 20, 2004 was discounted to December 1, 2004 at 5% and resulted in recognition of an unamortized discount of \$30,000 at December 1, 2004. The acquisition was funded through the use of cash on hand and a credit facility secured from the Company's principal lender.

The following unaudited pro forma information is presented to reflect the operations of the Company as if the acquisitions of the East Hobbs and the Fuhrman-Mascho properties had been completed on January 1, 2004:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2004	2005	2004
Oil and Gas Revenues	\$ 7,937,785	\$ 3,235,510	\$ 16,481,074	\$ 7,758,417
Net Income	3,460,207	823,227	6,505,433	1,902,985
Income Per Common Share				
Basic Net Income Per Common Share	\$ 0.30	\$ 0.10	\$ 0.62	\$ 0.25
Diluted Net Income Per Common Share	0.27	0.09	0.54	0.23

NOTE 4 - NOTES PAYABLE

In 2004 the Company established a \$25,000,000 credit facility with a bank that provided a \$15,000,000 borrowing base. Any increases in the borrowing base are subject to written consent by the financial institution. The interest rate is a floating rate equal to the 30, 60 or 90 day LIBOR rate plus 2.25%, currently 6.49% per annum, and is payable monthly. Annual fees for the facility were 1/8 of one percent of the unused portion of the borrowing base. Amounts borrowed under the revolving credit facility are due in April 2007. The revolving credit facility is secured by the Company's principal mineral interests. In order to obtain the revolving credit facility, loans from two officers were subordinated to the position of the bank. The Company is required under the terms of the credit facility to maintain a

tangible net worth of \$12,000,000, maintain a 5-to-1 ratio of income before interest, taxes, depreciation, depletion and amortization to interest expense and maintain a current asset to current liability ratio of 1-to-1.

ARENA RESOURCES, INC.
NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS
SEPTEMBER 30, 2005

Effective April 30, 2005, the Company entered into an agreement that increased its credit facility to \$50,000,000, with an increased borrowing base of \$35,000,000. At that time, the annual fee for the unused portion of the borrowing base was removed, the tangible net worth the Company must maintain was increased to \$18,000,000 and the maturity date changed to April 30, 2008. All other terms and conditions of the credit facility remained the same. During the nine months ended September 30, 2005, the Company paid the outstanding \$10,000,000 amount that was borrowed during 2004, using the proceeds from the exercise of warrants for the Company's common stock and the proceeds of the private sale of the Company's common stock. As of September 30, 2005, no amounts remained outstanding on this credit facility.

On September 30, 2005, two officers of the Company and the Board of Directors agreed to an extension of the \$400,000 notes payable to the two officers to January 1, 2007, under the same terms as the original notes.

NOTE 5 - ASSET RETIREMENT OBLIGATION

The Company provides for the obligation to plug and abandon oil and gas wells at the dates properties are acquired or the wells are drilled. The asset retirement obligation is adjusted each quarter for any liabilities incurred or settled during the period, accretion expense and any revisions made to the estimated cash flows. The reconciliation of the asset retirement obligation for the nine months ended September 30, 2005 is as follows:

Balance, January 1, 2005	\$ 1,267,993
Liabilities incurred	28,090
Accretion expense	74,484
Balance, September 30, 2005	\$ 1,370,567

NOTE 6 - STOCKHOLDERS' EQUITY

Shares issued in offering - In July 2005, the Company issued 970,874 shares of common stock, valued at \$10,000,000, or 10.30 per share, in a private placement. As a part of the negotiation process related to the terms of the private placement, the Company also assigned to certain of the investors call options to purchase 149,658 shares of its common stock at \$8.50 per share. The call options were granted in option agreements which were negotiated in connection with the issuance of shares of the Company's common stock in December 2004, as partial consideration for its purchase of interests in the Furhman-Mascho lease. The call terms in the option agreements provide the Company with the right to repurchase the shares issued in the Furhman-Mascho transaction at a price of \$8.50 per share, at any time prior to November 1, 2006. The option agreements further provide the stockholders who received shares in that transaction the right to require the Company to repurchase its stock from them at a price of \$7.00 per share (the public trading price of the common stock at the time of the Furhman-Mascho transaction) for a period of thirty days following November 1, 2006.

The proceeds from the offering have been allocated to the common stock issued and the call options transferred based on their relative fair values on July 11, 2005 and resulted in allocating \$9,238,427 to the 970,874 shares of common stock and \$561,573 to the 149,658 call options. The market value of the common stock on July 11, 2005 was \$12.88 per share. The fair value of the call options was \$5.08 per share determined by the Black-Scholes option pricing model using the following assumptions: volatility of 38.3%, risk-free interest rate of 3.6%, dividend yield of 0% and life of 1.0 years.

ARENA RESOURCES, INC.
NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS
SEPTEMBER 30, 2005

Warrants exercised - During the nine months ended September 30, 2005, the Company issued 2,374,398 shares of common stock for the exercise of warrants resulting in net proceeds of \$13,605,728. Exercise prices ranged from \$1.75 to \$7.32.

Shares issued in property acquisition - In March 2005, the Company issued 20,000 shares of restricted common stock, valued at \$261,600, or \$13.08 per share, as part of the acquisition cost for leasing acreage in Kansas as disclosed in Note 3.

The Company also issued 5,000 shares of restricted common stock, valued at \$79,050, or \$15.81 per share, as part of the acquisition cost for the acquisition of the Parrish properties in Texas as disclosed in Note 3.

Options issued - On January 1, 2005, the Company granted nonqualified stock options to directors and employees to purchase 375,000 shares of common stock at \$8.30 per share through July 1, 2010. The pro forma stock-based employee compensation expense determined under the fair value method for these options, net of related tax effects, for the year ending December 31, 2005 would be \$323,126.

Warrants extended - On June 30, 2005, the Company extended the expiration date of 36,250 warrants with an exercise price of \$1.75. The warrants were set to expire June 30, 2005 and were extended an additional six months to December 31, 2005. The incremental value associated with the extension of these warrants was determined to be immaterial.

NOTE 7 - CONTINGENCIES AND COMMITMENTS

Standby Letters of Credit - A commercial bank has issued standby letters of credit on behalf of the Company to the states of Texas, Oklahoma, New Mexico and Kansas totaling \$299,029 to allow the Company to do business in those states. The standby letters of credit are valid through May 2006 and are collateralized by the revolving credit facility with the bank. The Company intends to renew the standby letters of credit for as long as the Company does business in those states. No amounts have been drawn under the standby letters of credit.

NOTE 8 - SUBSEQUENT EVENTS

Subsequent to September 30, 2005, warrant holders exercised 559,625 warrants with an exercise price of \$7.32 per share, resulting in proceeds to the Company of \$4,096,455. These warrants were exercised in response to the Company's calling the warrants for redemption pursuant to a notice issued in late August 2005. Prior to September 30, 2005 but subsequent to the redemption notice, 906,428 warrants were exercised at the same exercise price.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Results of Operations - For the Three Months Ended September 30, 2005

Oil and natural gas sales. For the three months ended September 30, 2005, oil and natural gas sales revenue increased \$5,420,815 to \$7,937,785, compared to \$2,516,970 for the same period during 2004. Oil sales increased \$5,031,825 and natural gas sales increased \$388,990. The increases were the result of our acquisitions in 2004, increased sales volumes and average realized sales prices. For the three months ended September 30, 2005, oil sales volume increased 68,831 barrels to 123,600 barrels, compared to 54,769 barrels for the same period in 2004. The average realized per barrel oil price increased 43% from \$41.13 for the three months ended September 30, 2004 to \$58.92 for the three months ended September 30, 2005. For the three months ended September 30, 2005, gas sales volume increased 52,931 thousand cubic feet (MCF) to 105,629 MCF, compared to 52,698 MCF for the same period in 2004. The average realized natural gas price per MCF increased 23% from \$5.05 for the three months ended September 30, 2004 to \$6.20 for the three months ended September 30, 2005.

Lease operating expenses. Our lease operating expenses increased from \$564,933 or \$8.89 per barrel of oil equivalent (BOE) for the three months ended September 30, 2004 to \$946,380 or \$6.70 per BOE for the three months ended September 30, 2005. The increase in total was due to properties acquired in 2004. The decrease in the per BOE amounts is a result of increased production as a result of the development of our properties.

Production taxes. Our production taxes as a percentage of oil and natural gas sales decreased from 8% during the three months ended September 30, 2004 to 7% for the three months ended September 30, 2005. Production taxes vary from state to state. Therefore, these taxes are likely to vary in the future depending on the mix of production we generate from various states, as well as the possibility that any state may adjust its production tax.

Depreciation, depletion and amortization. Our depreciation, depletion and amortization expense increased by \$408,696 to \$645,908 for the three months ended September 30, 2005, compared to the same period in 2004. The increase was a result of an increase in volume and in the average depreciation, depletion and amortization rate from \$3.74 per BOE during the three months ended September 30, 2004 to \$4.52 per BOE during the three months ended September 30, 2005. The increased depreciation, depletion and amortization rate was the result of a revision to our reserves and increased capitalized costs and development costs from the properties acquired in 2004.

General and administrative expenses. General and administrative expenses increased by \$128,359 to \$259,978 for the three months ended September 30, 2005, compared to the same period in 2004. This increase was primarily related to increases in compensation expense associated with an increase in personnel required to administer our growth.

Interest expense (net of interest income). Interest expense decreased \$41,030 to \$19,266 for the three months ended September 30, 2005 when compared to the same period in 2004. The decrease was due to lower outstanding debt as a result of paying off amounts borrowed under our credit facility.

Income tax expense. Our effective tax rate was 37% during the three months ended September 30, 2004 and remained steady at 37% for the three months ended September 30, 2005.

Net income. Net income increased from \$830,049 for the three months ended September 30, 2004 to \$3,460,207 for the same period in 2005. The primary reasons for this increase include the acquisitions we made in 2004, development of our properties, an increase in volumes sold and higher crude oil prices between periods, partially offset by higher lease operating expense, general and administrative expense and income tax expense due to our growth.

Results of Operations - For the Nine Months Ended September 30, 2005

Oil and natural gas sales. For the nine months ended September 30, 2005, oil and natural gas sales revenue increased \$10,971,290 to \$16,481,074, compared to \$5,509,784 for the same period during 2004. Oil sales increased \$9,972,493 and natural gas sales increased \$998,797. The increases were the result of increased sales volumes and average realized sales prices. For the nine months ended September 30, 2005, oil sales volume increased 159,917 barrels to 293,094 barrels, compared to 133,177 barrels for the same period in 2004. The average realized per barrel oil price increased 36% from \$37.47 for the nine months ended September 30, 2004 to \$51.05 for the nine months ended September 30, 2005. For the nine months ended September 30, 2005, gas sales volume increased 161,188 thousand cubic feet (MCF) to 273,912 MCF, compared to 112,724 MCF for the same period in 2004. The average realized natural gas price per MCF increased 20% from \$4.62 for the nine months ended September 30, 2004 to \$5.55 for the nine months ended September 30, 2005.

Lease operating expenses. Our lease operating expenses increased from \$1,284,753 or \$8.45 per barrel of oil equivalent (BOE) for the nine months ended September 30, 2004 to \$2,384,816 or \$7.04 per BOE for the nine months ended September 30, 2005. The increase in total was due to properties acquired during 2004. The decrease in the per BOE amounts is a result of increased production as a result of the development of our properties.

Production taxes. Production taxes as a percentage of oil and natural gas sales were 7% during the nine months ended September 30, 2004 and remained steady at 7% for the nine months ended September 30, 2005. Production taxes vary from state to state. Therefore, these taxes are likely to vary in the future depending on the mix of production we generate from various states, as well as the possibility that any state may adjust its production tax.

Depreciation, depletion and amortization. Our depreciation, depletion and amortization expense increased by \$997,753 to \$1,550,791 for the nine months ended September 30, 2005, compared to the same period in 2004. The increase was a result of an increase in volume and in the average depreciation, depletion and amortization rate from \$3.64 per BOE during the nine months ended September 30, 2004 to \$4.52 per BOE during the nine months ended September 30, 2005. The increased depreciation, depletion and amortization rate was the result of a revision to our reserves and increased capitalized costs and development costs from the properties acquired in 2004.

General and administrative expenses. General and administrative expenses increased by \$329,691 to \$803,082 for the nine months ended September 30, 2005, compared to the same period in 2004. This increase was primarily related to increases in compensation expense associated with an increase in personnel required to administer our growth.

Interest expense (net of interest income). Interest expense increased \$61,135 to \$189,542 for the nine months ended September 30, 2005 when compared to the same period in 2004. The increase was due to an increase in our average outstanding debt with the use of our credit facility in the acquisition of the Fuhrman-Mascho properties in December 2004.

Income tax expense. Our effective tax rate was 37% during the nine months ended September 30, 2004 and remained steady at 37% for the nine months ended September 30, 2005.

Net income. Net income increased from \$1,688,239 for the nine months ended September 30, 2004 to \$6,505,433 for 2005. The primary reasons for this increase include acquisitions we made in 2004, development of our properties, an increase in volumes sold and higher crude oil prices between periods, partially offset by higher lease operating expense, general and administrative expense and income tax expense due to our growth.

Revenues Year to Date by Geographic section

Arena reports its net oil and gas revenues for the year to date as applicable to the following geographic sectors:

OIL

	<u>Net Production Volume</u>		<u>Net Revenue</u>
Texas Leases	118,721	BBLs	\$ 6,152,189
O k l a h o m a Leases	43,897	BBLs	\$ 2,344,304
N e w M e x i c o Leases	130,476	BBLs	\$ 6,465,537

GAS

	<u>Net Production Volume</u>		<u>Net Revenue</u>
Texas Leases	48,279	MCF	\$ 228,104
O k l a h o m a Leases	31,064	MCF	\$ 120,139
N e w M e x i c o Leases	108,063	MCF	\$ 809,866
Kansas	86,506	MCF	\$ 360,935

Significant Subsequent Events occurring after September 30, 2005:

Subsequent to September 30, 2005, warrant holders exercised 559,625 warrants with an exercise price of \$7.32 per share, resulting in proceeds to the Company of \$4,096,455. These warrants were exercised in response to the Company's calling the warrants for redemption pursuant to a notice issued in late August 2005. Prior to September 30, 2005 but subsequent to the redemption notice, 906,428 warrants were exercised at the same exercise price.

Capital Resources and Liquidity

As shown in the financial statements for the nine months ended September 30, 2005, the Company had cash on hand of \$6,571,237, compared to \$1,253,969 as of December 31, 2004. The Company had positive net cash flows from operations for the nine months ended September 30, 2005 of \$9,858,079, compared to \$3,414,117 for the same period 2004. Other significant sources of cash inflow include the receipt of net proceeds of \$13,605,728 during the nine months ended September 30, 2005 and \$189,500 for the same period in 2004 from the exercise of warrants for the Company's common stock, \$9,916,750 net proceeds from the private placement of common stock in July 2005, \$8,434,823 net proceeds from the Company's secondary public offering in August 2004 and \$1,000,000 from the issuance of notes payable in 2004. The most significant cash outflows during the nine months ended September 30, 2005 and 2004 were capital expenditures of \$18,063,288 in 2005 and \$2,277,703 in 2004, repayment of debt on the Company's credit facility of \$10,000,000 in 2005 and \$10,008,440 in 2004.

In 2004 the Company established a \$25,000,000 credit facility with a bank that provided a \$15,000,000 borrowing base. Any increases in the borrowing base are subject to written consent by the financial institution. The interest rate is a floating rate equal to the 30, 60 or 90 day LIBOR rate plus 2.25%, currently 6.49% per annum, and is payable monthly. Annual fees for the facility were 1/8 of one percent of the unused portion of the borrowing base. Amounts borrowed under the revolving credit facility are due in April 2007. The revolving credit facility is secured by the Company's principal mineral interests. In order to obtain the revolving credit facility, loans from two officers were subordinated to the position of the bank. The Company is required under the terms of the credit facility to maintain a tangible net worth of \$12,000,000, maintain a 5-to-1 ratio of income before interest, taxes, depreciation, depletion and

amortization to interest expense and maintain a current asset to current liability ratio of 1-to-1.

Effective April 30, 2005, the Company entered into an agreement that increased its credit facility to \$50,000,000, with an increased borrowing base of \$35,000,000. At that time, the annual fee for the unused portion of the borrowing base was removed, the tangible net worth the Company must maintain was increased to \$18,000,000 and the maturity date changed to April 30, 2008. All other terms and conditions of the credit facility remained the same. During the nine months ended September 30, 2005, the Company paid the outstanding \$10,000,000 amount that was borrowed during 2004, using the proceeds from the exercise of warrants for the Company's common stock and the proceeds of the private sale of the Company's common stock. As of September 30, 2005, no amounts remained outstanding on this credit facility.

Disclosures About Market Risks

Like other natural resource producers, Arena faces certain unique market risks. The two most salient risk factors are the volatile prices of oil and gas and certain environmental concerns and obligations.

Oil and Gas Prices

Current competitive factors in the domestic oil and gas industry are unique. The actual price range of crude oil is largely established by major international producers. Pricing for natural gas is more regional. Because domestic demand for oil and gas exceeds supply, there is little risk that all current production will not be sold at relatively fixed prices. To this extent Arena does not see itself as directly competitive with other producers, nor is there any significant risk that the Company could not sell all production at current prices with a reasonable profit margin. The risk of domestic overproduction at current prices is not deemed significant. The primary competitive risks would come from falling international prices which could render current production uneconomical.

Secondarily, Arena is presently committed to use the services of the existing gatherers in its present areas of production. This gives to such gatherers certain short term relative monopolistic powers to set gathering and transportation costs, because obtaining the services of an alternative gathering company would require substantial additional costs since an alternative gatherer would be required to lay new pipeline and/or obtain new rights-of-way in the lease.

It is also significant that more favorable prices can usually be negotiated for larger quantities of oil and/or gas product, such that Arena views itself as having a price disadvantage to larger producers. Large producers also have a competitive advantage to the extent they can devote substantially more resources to acquiring prime leases and resources to better find and develop prospects.

Environmental

Oil and gas production is a highly regulated activity which is subject to significant environmental and conservation regulations both on a federal and state level. Historically, most of the environmental regulation of oil and gas production has been left to state regulatory boards or agencies in those jurisdictions where there is significant gas and oil production, with limited direct regulation by such federal agencies as the Environmental Protection Agency. However, while the Company believes this generally to be the case for its production activities in Texas, Oklahoma, Kansas and New Mexico, it should be noticed that there are various Environmental Protection Agency regulations which would govern significant spills, blow-outs, or uncontrolled emissions.

In Oklahoma, Texas, Kansas and New Mexico specific oil and gas regulations exist related to the drilling, completion and operations of wells, as well as disposal of waste oil. There are also procedures incident to the plugging and abandonment of dry holes or other non-operational wells, all as governed by the Oklahoma Corporation Commission, Oil and Gas Division, the Texas Railroad Commission, Oil and Gas Division, the Kansas Corporation Commission, Oil and Gas Division or the New Mexico Oil Conservation Division.

Compliance with these regulations may constitute a significant cost and effort for Arena. No specific accounting for environmental compliance has been maintained or projected by Arena to date. Arena does not presently know of any environmental demands, claims, or adverse actions, litigation or administrative proceedings in which it or the acquired properties are involved or subject to or arising out of its predecessor operations.

In the event of a breach of environmental regulations, these environmental regulatory agencies have a broad range of alternative or cumulative remedies to include: ordering a clean up of any spills or waste material and restoration of the soil or water to conditions existing prior to the environmental violation; fines; or enjoining further drilling, completion or production activities. In certain egregious situations the agencies may also pursue criminal remedies against the Company or its principals.

Forward-Looking Information

Certain statements in this Section and elsewhere in this report are forward-looking in nature and relate to trends and events that may affect the Company's future financial position and operating results. Such statements are made pursuant to the safe harbor provision of the *Private Securities Litigation Reform Act of 1995*. The terms "expect," "anticipate," "intend," and "project" and similar words or expressions are intended to identify forward-looking statements. These statements speak only as of the date of this report. The statements are based on current expectations, are inherently uncertain, are subject to risks, and should be viewed with caution. Actual results and experience may differ materially from the forward-looking statements as a result of many factors, including changes in economic conditions in the markets served by the company, increasing competition, fluctuations in raw materials and energy prices, and other unanticipated events and conditions. It is not possible to foresee or identify all such factors. The company makes no commitment to update any forward-looking statement or to disclose any facts, events, or circumstances after the date hereof that may affect the accuracy of any forward-looking statement.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

The Company is subject to interest rate risk on its revolving credit facility, which bears variable interest based upon a LIBOR rate. Changes in interest rates affect the interest earned on the Company's cash and cash equivalents and the interest rate paid on borrowings under its bank credit facility. Currently, the Company does not use interest rate derivative instruments to manage exposure to interest rate changes.

Commodity Price Risk

The Company's revenues, profitability and future growth depend substantially on prevailing prices for oil and natural gas. Prices also affect the amount of cash flow available for capital expenditures and Arena's ability to borrow and raise additional capital. The amount the Company can borrow under its bank credit facility is subject to periodic redetermination based in part on changing expectations of future prices. Lower prices may also reduce the amount of oil and natural gas that the Company can economically produce. Arena currently sells all of its oil and natural gas production under price sensitive or market price contracts.

Arena does not currently use derivative commodity instruments or similar financial instruments to attempt to hedge commodity price risks associated with future oil and natural gas production.

Currency Exchange Rate Risk

Foreign sales accounted for none of the Company's sales; further, the Company accepts payment for its commodity sales only in U.S. dollars; hence, Arena is not exposed to foreign currency exchange rate risk on these sales.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company maintains controls and procedures designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. At the end of the period covered by this Quarterly Report on Form 10-Q, the Company's management, under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that as of the end of such period the Company's disclosure control and procedures are effective in alerting them to material information that is required to be included in the reports the Company files or submits under the Securities Exchange Act of 1934.

Changes in Internal Controls Over Financial Reporting

There have been no changes in the Company's internal control over financial reporting during the most recent fiscal quarter that have materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Part II - Other Information

Item 1. Legal Proceedings

None.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

During the three months ended September 30, 2005, the Company issued 74,204 shares of common stock as a result of warrant holders exercising warrants which had an exercise price of \$5.00 per share. The Company received \$371,020 from the exercises. The shares were issued in transactions not involving a public offering in reliance upon the exemption from registration provided by Section 4(2) of the Securities Act of 1933. The persons to whom the shares were issued in exchange for the warrants had access to full information concerning the Company and represented that they acquired the shares for their own account and not for the purpose of distribution. The certificates for the shares contain a restricted legend advising that the shares may not be offered for sale, sold or otherwise transferred without having first been registered under the 1933 Act or pursuant to an exemption from registration under the 1933 Act. There was no underwriter involved in these transactions.

During the three months ended September 30, the Company issued 970,874 shares of common stock, valued at \$10,000,000, or 10.30 per share, in a private placement. The shares were issued in a transaction not involving a public offering to accredited investors in reliance upon the exemption from registration provided by Section 4(2) of the Securities Act of 1933. The persons to whom the shares were issued in the private placement had access to full information concerning the Company and represented that they acquired the shares for their own account and not for the purpose of distribution. The certificates for the shares contain a restricted legend advising that the shares may not be offered for sale, sold or otherwise transferred without having first been registered under the 1933 Act or pursuant to an exemption from registration under the 1933 Act. There was no underwriter involved in these transactions.

During the three months ended September 30, 2005, the Company issued 5,000 shares of common stock, valued at \$79,050, or \$15.81 per share, in connection with the Company's acquisition of the Parrish properties. The shares were issued in transactions not involving a public offering in reliance upon the exemption from registration provided by Section 4(2) of the Securities Act of 1933. The persons to whom the shares were issued in exchange for the warrants had access to full information concerning the Company and represented that they acquired the shares for their own account and not for the purpose of distribution. The certificates for the shares contain a restricted legend advising that the shares may not be offered for sale, sold or otherwise transferred without having first been registered under the 1933 Act or pursuant to an exemption from registration under the 1933 Act. There was no underwriter involved in these transactions.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6.

Exhibits

- (a) Exhibit 31.1 Section 302 Certification of CEO
- Exhibit 31.2 Section 302 Certification of CFO

- (b) Exhibit 32.1 Section 1350 Certification of CEO
- Exhibit 32.2 Section 1350 Certification of CFO

SIGNATURES

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

**REGISTRANT: ARENA RESOURCES,
INC.**

Dated: October 31, 2005

By: /s/ Lloyd Tim
Rochford
Lloyd Tim Rochford
President, Chief Executive Officer

Dated: October 31, 2005

By: /s/ Stanley
McCabe
Stanley McCabe
Treasurer, Secretary

Dated: October 31, 2005

By: /s/ William R.
Broadrick
William R. Broadrick
Vice President, Chief Financial Officer