

CONTANGO OIL & GAS CO  
Form 10-K/A  
August 10, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-K/A**

(AMENDMENT NO. 1)

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(Mark One)

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

For the fiscal year ended June 30, 2006

**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 001-16317

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**CONTANGO OIL & GAS COMPANY**

(Exact name of registrant as specified in its charter)

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Delaware  
(State or other jurisdiction of  
incorporation or organization)

3700 Buffalo Speedway, Suite 960

Houston, Texas 77098

95-4079863  
(IRS Employer

Identification No.)

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(Address of principal executive offices)

(713) 960-1901

(Registrant's telephone number, including area code)

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**Securities registered pursuant to Section 12(b) of the Act:**

**Common Stock, Par Value \$0.04 per share**

**American Stock Exchange**

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

The aggregate market value of the common equity held by non-affiliates computed by reference to the average bid and asked price of such common equity at the close of business on December 31, 2005, was \$133,853,434. As of August 31, 2006, there were 15,015,835 shares of the registrant's common stock outstanding.

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**EXPLANATORY NOTE**

Contango Oil & Gas Company (the Company, Contango, we, our, us) is hereby amending its previously filed Annual Report on Form 10-K the fiscal year ended June 30, 2006 (the Original Filing). This Amendment No. 1 (the Amendment) is being filed solely to amend the following items:

Item 7 *Management's Discussion and Analysis of Financial Condition and Results of Operations*, has been revised to replace the discussion in the Original Report that was based on activity of continuing and discontinued operations combined, which was presented without differentiation and was inconsistent with the financial statement presentation. The new discussion focuses on continuing operations apart from discontinued operations in accordance with generally accepted accounting principles (GAAP) and the provisions of Item 303(a) of Regulation S-K, and addresses the judgment and estimation attributes of our critical accounting policies;

Footnote No. 2 to the Consolidated Financial Statements *Summary of Significant Accounting Policies, Principles of Consolidation*, has been revised to more clearly explain the consolidation policy of our non-wholly owned subsidiaries;

Footnote No. 9 to the Consolidated Financial Statements *Contango Venture Capital Corporation*, has been revised to more clearly describe the accounting method applied to our alternative energy investments.

**Other than as specified above, this Amendment does not modify or affect the financial statements in the Original Filing.** As a result of this Amendment, the certifications filed as Exhibit 31.1 and Exhibit 32.1 have been re-executed as of the date of this Amendment. This Amendment does not reflect events occurring after the filing of the Original Filing or modify or update the disclosures therein in any way other than as described above. In accordance with Rule 12b-15 promulgated under the Securities Exchange Act of 1934, the complete text of each affected item, as amended, is included herein. Unaffected items have not been repeated in this Amendment.

**PART II**

**Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations***

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the financial statements and the related notes and other information included elsewhere in this report.*

**Overview**

Contango is a Houston-based, independent natural gas and oil company. The Company's core business is to explore, develop, produce and acquire natural gas and oil properties primarily offshore in the Gulf of Mexico and in the Arkansas Fayetteville Shale. Contango Operators, Inc. (COI), our wholly-owned subsidiary, acts as operator on certain offshore prospects. The Company also owns a 10% interest in a limited partnership formed to develop an LNG receiving terminal in Freeport, Texas, and holds investments in companies focused on commercializing environmentally preferred energy technologies.

As stated in the Explanatory Note above, we are revising the Results of Operations below to focus only on continuing operations, rather than combining continuing operations with the results of our discontinued operations. In addition to the changes in the narratives, the tabular information shown has also been revised to be consistent with our GAAP-based financial statements. We have also added a discontinued operations subsection near the end of our Results of Operations narrative to briefly discuss the activity in our financial statements that is associated with the discontinued operations. The Capital Sources and Liquidity section has also been revised to replace our non-GAAP measures of cash inflow and cash outflow with GAAP measures of cash flow for operating, investing and financing activities.

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*Revenues and Profitability.* Our revenues, profitability and future growth depend substantially on prevailing prices for natural gas and oil and on our ability to find, develop and acquire natural gas and oil reserves that are economically recoverable and the completion and successful operation of our Freeport LNG project. The preparation of our financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect our reported results of operations and the amount of reported assets, liabilities and proved natural gas and oil reserves. We use the successful efforts method of accounting for our natural gas and oil activities.

*Reserve Replacement.* Generally, our producing properties in the Arkansas Fayetteville Shale and offshore in the Gulf of Mexico have high initial production rates, followed by steep declines. As a result, we must locate and develop or acquire new natural gas and oil reserves to replace those being depleted by production. Substantial capital expenditures are required to find, develop and acquire natural gas and oil reserves.

*Sale of proved properties.* From time-to-time as part of our business strategy, we have sold, and in the future may continue to sell some or a substantial portion of our proved reserves to capture current value, using the sales proceeds to further our exploration, LNG and alternative energy investment activities.

*Use of Estimates.* The preparation of our financial statements requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. Significant estimates with regard to these financial statements include estimates of remaining proved natural gas and oil reserves and the timing and costs of our future drilling, development and abandonment activities.

Please see **Risk Factors** on page 18 for a more detailed discussion of a number of other factors that affect our business, financial condition and results of operations.

## **Results of Operations**

The following is a discussion of the results of our operations for the fiscal year ended June 30, 2006, compared to the fiscal year ended June 30, 2005 and for the fiscal year ended June 30, 2005, compared to the fiscal year ended June 30, 2004.

*Revenues.* All of our revenues are from the sale of our natural gas and oil production. Our revenues may vary significantly from year to year depending on changes in commodity prices, which fluctuate widely, and production volumes. Our production volumes are subject to wide swings as a result of new discoveries and ongoing geological declines.

The table below sets forth revenue and production data for continuing operations for the fiscal years ended June 30, 2006, 2005 and 2004.

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	Year ended June 30,			Year ended June 30,		
	2006	2005	%	2005	2004	%
	(\$000)			(\$000)		
<b>Revenues:</b>						
Natural gas and oil sales	\$ 920	\$ 1,089	-16%	\$ 1,089	\$ 107	918%
Gain from hedging activities			0%		58	-100%
Total revenues	\$ 920	\$ 1,089		\$ 1,089	\$ 165	
<b>Production:</b>						
Natural gas (million cubic feet)	91	71	28%	71	8	788%
Oil and condensate (thousand barrels)	4	8	-50%	8	2	300%
Total (million cubic feet equivalent)	115	119	-3%	119	20	495%
Natural gas (thousand cubic feet per day)	249	195	28%	195	22	786%
Oil and condensate (barrels per day)	11	22	-50%	22	5	340%
Total (thousand cubic feet per day equivalent)	315	327	-4%	327	52	529%
<b>Average Sales Price:</b>						
Natural gas (per thousand cubic feet)	\$ 7.15	\$ 8.40	-15%	\$ 8.40	\$ 5.29	59%
Oil and condensate (per barrel)	\$ 61.53	\$ 58.93	4%	\$ 58.93	\$ 29.21	102%
Operating expenses	\$ 13	\$ 20	-35%	\$ 20	\$ 90	-78%
Exploration expenses	\$ 8,202	\$ 5,870	40%	\$ 5,870	\$ 6,365	-8%
Depreciation, depletion and amortization	\$ 233	\$ 352	-34%	\$ 352	\$ 41	759%
Impairment of natural gas and oil properties	\$ 708	\$ 237	199%	\$ 237	\$ 43	451%
General and administrative expenses	\$ 4,761	\$ 3,571	33%	\$ 3,571	\$ 2,696	32%
Interest expense, net of interest capitalized	\$ 54	\$ 71	-24%	\$ 71	\$ 362	-80%
Interest income	\$ 826	\$ 432	91%	\$ 432	\$ 38	1037%
Gain on sale of marketable securities	\$	\$	0%	\$	\$ 710	-100%
Gain on sale of assets and other	\$ 250	\$ 705	-65%	\$ 705	\$ 6,188	-89%

*Natural Gas and Oil Sales.* We reported natural gas and oil sales of approximately \$0.9 million for the year ended June 30, 2006, down from approximately \$1.1 million reported for the year ended June 30, 2005. The slight decrease mainly reflects normal production declines and a decrease in the average price received for natural gas, partially offset by an increase in the average price received for our oil production and newly added reserves and production from our Arkansas Fayetteville Shale play that recently began producing.

We reported natural gas and oil sales of approximately \$1.1 million for the year ended June 30, 2005, up from approximately \$0.1 million reported for the year ended June 30, 2004. This increase reflects mainly added production from newly added reserves and production from our partially owned subsidiaries, REX and COE, along with an increase in average prices received for our natural gas and oil production.

*Natural Gas and Oil Production and Average Sales Prices.* Our net natural gas production for the year ended June 30, 2006 was approximately 249 Mcf/d, up from approximately 195 Mcf/d for the year ended June 30, 2005. Net oil production for the period was down from 22 barrels of oil per day to 11 barrels of oil per day. The increase in natural gas production was primarily the result of additional production from our Arkansas Fayetteville Shale play. The decrease in oil and condensate production is mainly attributable to normal production declines. For the year ended June 30, 2006, prices for natural gas and oil were \$7.15 per Mcf and \$61.53 per barrel, compared to \$8.40 per Mcf and \$58.93 per barrel for the year ended June 30, 2005.

For the year ended June 30, 2005, our net natural gas production was approximately 195 Mcf/d, up from approximately 22 Mcf/d for the year ended June 30, 2004. Net oil production for the period was up from 5 barrels of oil per day to 22 barrels of oil per day. These increases were primarily due to added production from newly added reserves and production from our partially owned subsidiaries, REX and COE. For the year ended June 30, 2005, prices for natural gas and oil were \$8.40 per Mcf and \$58.93 per barrel, up from \$5.29 per Mcf and \$29.21 per barrel for the year ended June 30, 2004.

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*Gain (loss) from Hedging Activities.* The Company did not engage in any hedging activity for the fiscal years ended June 30, 2006 and 2005. We reported a gain from hedging activities for the year ended June 30, 2004 of \$58,171.

*Operating Expenses.* Operating expenses for the year ended June 30, 2006 were \$13,350 which relate to continuing operations from our offshore activities and the Arkansas Fayetteville Shale play.

Operating expenses for the year ended June 30, 2005 and June 30, 2004 were \$19,683 and \$90,336, respectively, which related to continuing operations from our offshore activities.

*Exploration Expense.* We reported approximately \$8.2 million of exploration expenses for the year ended June 30, 2006. Of this amount, approximately \$1.2 million was related to unsuccessful wells drilled during the period, approximately \$5.9 million was related to unsuccessful wells drilled in the Gulf of Mexico during the period, approximately \$0.5 million was attributable to the cost to acquire and reprocess 3-D seismic data both onshore along the Gulf Coast and offshore in the Gulf of Mexico, approximately \$0.6 million was attributable to the cost of delay rentals.

We reported approximately \$5.9 million of exploration expenses for the year ended June 30, 2005. Of this amount, approximately \$3.1 million was related to unsuccessful wells drilled in south Texas, approximately \$0.8 million was related to unsuccessful wells drilled in the Gulf of Mexico during the period, approximately \$1.6 million was attributable to the cost to acquire and reprocess 3-D seismic data both onshore along the Gulf Coast and offshore in the Gulf of Mexico, and \$0.4 million was attributable to the cost of delay rentals.

We reported approximately \$6.4 million of exploration expenses for the year ended June 30, 2004. Of this amount, approximately \$0.1 million was attributable to dry holes drilled in south Texas, approximately \$2.7 million was attributable to seismic costs and delay rentals associated with activities onshore in south Texas and approximately \$3.6 million was attributable to seismic costs and delay rentals associated with activities offshore in the Gulf of Mexico.

*Depreciation, Depletion and Amortization.* Depreciation, depletion and amortization for the year ended June 30, 2006 was approximately \$0.2 million. For the year ended June 30, 2005, we recorded approximately \$0.4 million of depreciation, depletion and amortization. The decrease in depreciation, depletion and amortization was primarily the result of normal production declines.

Depreciation, depletion and amortization for the fiscal years ended June 30, 2005 and 2004 were \$352,114 and \$40,807, respectively. This increase was primarily attributable to added production from newly added reserves and production from COE.

*Impairment of Natural Gas and Oil Properties.* We reported an impairment of natural gas and oil properties of approximately \$0.7 million for the year ended June 30, 2006. These related to impairment of offshore properties held by REX and COE. When Contango acquired an additional interest in REX and COE, the purchase price was allocated to several prospects. Specifically, \$0.3 million related to our Main Pass 221 prospect and \$0.3 million related to our West Delta 43 prospect were impaired because they were both determined to be dry holes during the period; and \$0.1 million relating to our East Cameron 107 prospect was impaired as a result of the expiration of its lease.

We reported an impairment of natural gas and oil properties of approximately \$0.2 million for the year ended June 30, 2005. This was attributable in part to a \$0.1 million write-down of costs associated with offshore lease properties owned by our partially owned subsidiary MOE, of which Contango owns 50%. The remaining \$0.1 million was attributable to a write-down of costs associated with a small Barnett Shale exploratory play undertaken during the summer of 2003 that had only marginal success.

Impairment expense for the year ended June 30, 2004 was approximately \$43,000 which related to impairment of properties held by REX and MOE.

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*General and Administrative Expenses.* General and administrative expenses for the year ended June 30, 2006 were approximately \$4.8 million, up from \$3.6 million for the year ended June 30, 2005. Major components of general and administrative expenses for the year ended June 30, 2006 included approximately \$1.8 million in salaries, benefits and bonuses, \$0.9 million in office administration and other expenses, \$0.3 million in insurance costs, \$0.5 million in accounting and tax services, \$0.4 million in legal and other administrative expenses, and \$0.9 million in non-cash expenses related to the cost of expensing stock options.

General and administrative expenses for the year ended June 30, 2005 were approximately \$3.6 million, up from \$2.7 million for the year ended June 30, 2004. Major components of general and administrative expenses for the year ended June 30, 2005 included approximately \$1.3 million in salaries, benefits and bonuses, \$1.2 million in office administration and other expenses, \$0.3 million in insurance costs, \$0.4 million in legal and other professional fees and other administrative expenses, and \$0.4 million in non-cash expenses related to the cost of expensing stock options.

General and administrative expenses for the year ended June 30, 2004 were approximately \$2.7 million. Major components included approximately \$0.7 million in salaries and benefits, \$0.5 million of legal, accounting, engineering and other professional fees, \$0.4 million of office administration and \$0.3 million of insurance costs. Also included in total general and administrative expenses for the year ended June 30, 2004 was approximately \$0.3 million related to the cost of expensing stock options, \$0.2 million related to our Gulf of Mexico exploration activities, \$0.1 million for compensation expense to our board of directors and \$0.2 million in other expenses.

*Interest Expense.* Interest expense for the fiscal years ended June 30, 2006, 2005 and 2004 were approximately \$54,488, \$71,506, and \$362,127, respectively. The higher level of interest expense for fiscal year 2004 was attributable to a higher level of bank debt outstanding during such period. The lower levels of interest expense in fiscal years 2005 and 2006 were attributable to the Company retiring all of its long term debt in the second quarter of fiscal year 2005. Interest of \$149,365 was capitalized for unevaluated property for the fiscal year ended June 30, 2006.

*Interest Income.* Interest income for the fiscal years ended June 30, 2006, 2005 and 2004 were approximately \$0.8 million, \$0.4 million and \$38,182, respectively. The higher level of interest income for fiscal year 2005 was attributable to six months of interest earned on the proceeds from the sale of our south Texas natural gas and oil interests to Edge Petroleum in December 2004. The even higher level of interest income in fiscal year 2006 was attributable to 12 months of interest on the remaining proceeds from the sale of our south Texas natural gas and oil interest to Edge Petroleum, plus interest earned on the proceeds from property sales effective February 1, 2006 and April 1, 2006.

*Gain on Sale of Assets and Other.* We reported a gain on sale of assets and other of approximately \$0.3 million for the year ended June 30, 2006, which represents other income recognized by our partially-owned subsidiary, COE.

We reported gain on sale of assets and other of approximately \$0.7 million for the year ended June 30, 2005, which represented a \$0.8 million unrealized gain recorded as a result of a mark-to-market increase in the value of our alternative energy investments, offset by approximately \$0.1 million in operating losses related to our alternative energy investments.

For the year ended June 30, 2004, we reported an approximate \$6.2 million gain on the sale of assets and other. In December 2003, Contango and its 42.7%-owned subsidiary, REX, sold their producing Gulf of Mexico leases for approximately \$12.0 million. As a result of this sale, Contango recorded a gain of approximately \$6.2 million as of June 30, 2004. Properties included in the sale were Eugene Island 110, Grand Isle 28 and High Island 25-L. Because the interests sold were unearned back-in working interests, Contango had no proved reserves attributable to the properties sold.

*Discontinued Operations.* The table and discussions above, along with our financial statements, discuss only continuing operations. Not reflected are the Company's sold producing properties which generated 84.1%, 93.3% and 99.6% of combined revenues for the fiscal years ended June 30, 2006, 2005 and 2004, respectively. Please see Note 3 - Sale of Properties - Discontinued Operations, for a discussion of our discontinued operations.

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The Company, since its inception in September 1999, has raised \$80.0 million in proceeds from seven separate property sales, and views periodic reserve sales as an opportunity to capture value, reduce reserve and price risk, in addition to being a source of funds for potentially higher rate of return natural gas and oil exploration investments. We believe these periodic natural gas and oil property sales are an efficient strategy to meet our cash and liquidity needs by providing us with immediate cash, which would otherwise take years to realize through the production lives of the fields sold. We have in the past and expect to in the future to continue to rely heavily on the sales of assets to generate cash to fund our exploration investments and operations.

These sales bring forward future revenues and cash flows, but our longer term liquidity could be impaired to the extent our exploration efforts are not successful in generating new discoveries, production, revenues and cash flows. Additionally, our longer term liquidity could be impaired due to the decrease in our inventory of producing properties that could be sold in future periods. Further, as a result of these property sales the Company's ability to collateralize bank borrowings is reduced which increases our dependence on more expensive mezzanine debt and potential equity sales. The availability of such funds will depend upon prevailing market conditions and other factors over which we have no control, as well as our financial condition and results of operations.

The table below sets forth the proceeds received from property sales in each of the fiscal years ended June 30, 2004, 2005 and 2006, the impact of these sales on our developed reserve quantities, and a measure of our developed reserves held at the end of each such fiscal year. Please see the reserve activity reported in the Supplemental Oil and Gas Disclosures on pages F-28 and F-29 for a more detailed discussion regarding our standardized measure.

Fiscal Year of Property Sale	Proceeds Received	Reserves Sold (Mmcfe)	Reserves at end of Fiscal Year (Mmcfe)	Standardized Measure of Discounted Future Net Cash
				Flows at end of Fiscal Year
2004	\$ 7,766,379	1,322	17,415	\$ 44,978,752
2005	40,131,428	16,015	1,373	5,250,600
2006	12,892,916	2,294	3,430	7,734,106

For fiscal year 2006, the Company realized \$8.3 million in operating cash flows from discontinued operations, \$9.9 million in investing cash flows from discontinued operations and \$1.6 million in financing cash flows from discontinued operations.

*Operating Activities.* Our operating activities provided approximately \$9.5 million in cash for the year ended June 30, 2006 compared to \$4.9 million for the same period in 2005. The increase in cash from operating activities is primarily attributable to increased production as we redeployed the money raised in our December 2004 property sale to Edge Petroleum Corporation ( Edge ) to drill and develop new onshore wells.

Our operating activities provided approximately \$4.9 million in cash for the year ended June 30, 2005 compared to \$13.1 million for the same period in 2004. This decrease in cash from operating activities is primarily attributable to the sale of approximately 16 billion cubic feet equivalent of proven reserves to Edge in December 2004.

*Investing Activities.* Cash flows used in investing activities for the year ended June 30, 2006 were approximately \$23.7 million, compared to cash flows provided by investing activities for the year ended June 30, 2005 of approximately \$4.2 million. This increase in capital expenditures is primarily attributable to investing \$34.1 million in natural gas and oil properties with funds received from our sale to Edge in December 2004, slightly offset by selling approximately \$7.0 million of short-term investments. Additionally, we invested \$2.4 million in our Freeport LNG project and alternative energy companies, and \$8.5 million on acquiring additional offshore interests and ownership interests in REX and COE.



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Cash flows provided by investing activities for the year ended June 30, 2005 were approximately \$4.3 million, compared to cash flows used in investing activities for the year ended June 30, 2004 of approximately \$4.9 million. This increase in cash flow is primarily attributable to the \$40.1 million received from our sale of natural gas and oil properties to Edge in December 2004, partially offset by purchasing \$25.5 million of short-term investments.

*Financing Activities.* Cash flows provided by financing activities for the year ended June 30, 2006 were approximately \$20.5 million, compared to cash flows used in financing activities for the year ended June 30, 2005 of approximately \$5.6 million. This increase in cash flow is primarily attributable to borrowing \$10.0 million of long term debt and raising approximately \$9.6 million from the issuance of our Series D convertible preferred equity securities, net of issuance costs.

Cash flows used in financing activities for the year ended June 30, 2005 were approximately \$5.6 million compared to \$8.1 million for the same period in 2004. The decrease in expenditures is primarily attributable to repaying approximately \$9.3 million of debt in 2005, compared to \$37.5 million in 2004. The repayments were slightly offset by borrowing \$2.2 million of long term debt in 2005, compared to \$22.2 million in 2004.

*Capital Budget.* For fiscal year 2007, our capital expenditure budget calls for us to invest a total of \$58.3 million, as we anticipate significantly increasing our capital commitment for developing our Arkansas Fayetteville Shale play, drilling our Eugene Island 10 ( Dutch ) exploration well, and bringing our Grand Isle 72 ( Liberty ) discovery to production.

Of the \$58.3 million fiscal year 2007 capital expenditure budget, \$13.0 million is anticipated to be invested in offshore activities. Our budget calls for us to invest approximately \$2.2 million for production and pipeline facilities for developing Grand Isle 72, approximately \$3.7 million for our share of the dry hole drilling costs for Eugene Island 10, our Dutch prospect, approximately \$3.6 million for our share of the drilling and casing costs for Grand Isle 70, our Red Queen discovery, and \$3.5 million in projected future exploration costs, seismic and delay rentals. We have not yet identified the offshore prospects we intend to drill during the remainder of fiscal year 2007, but in the event we have exploration success at our Dutch prospect, our capital budget will be significantly increased as we will incur additional costs to complete the well and pay for production facilities in addition to follow-on development wells. In addition, depending on how we choose to develop our Grand Isle 70 discovery, our capital budget could be further increased.

Of the \$58.3 million fiscal year 2007 capital expenditure budget, \$45.3 million is expected to be invested in onshore activities. In the Arkansas Fayetteville Shale, our partners and we have acquired or received commitments on approximately 44,000 net mineral acres and we have received AFEs and committed to a total of 69 wells in this play as of August 31, 2006. Of these 69 wells, 15 are operated by Alta and 54 are operated by a third party independent oil and gas exploration company ( Integrated Wells ). We have an average working interest of 15.19%, and a net revenue interest of 12.04% in these 69 wells.

Of the 15 Alta wells, one well was drilled during fiscal year 2006. We are budgeting to receive an additional six AFEs from Alta for wells to be drilled during fiscal year 2007, and therefore expect to drill 20 Alta wells during fiscal year 2007 at a cost of \$23.3 million. This includes drilling, frac, completion and hookup costs for the wells. Additionally, we expect to invest \$3.2 million in infrastructure, seismic and additional leasehold costs for the Arkansas Fayetteville Shale. We estimate we will have an average working interest of 43%, and a net revenue interest of 34% in these 21 Alta wells.

Of the 54 Integrated Wells for which we have received an AFE, 16 wells are producing, 19 wells have already been spud, and 19 wells have yet to be drilled. In addition to these 54 Integrated Wells, we are budgeting to receive 57 additional AFEs for Integrated Wells during the remainder of fiscal year 2007 for a total of 111 Integrated Wells. We anticipate having between 40 to 50 producing Integrated Wells by December 2006. Our capital budget for Integrated Wells assumes we will invest \$16.6 million in Integrated Wells during fiscal year 2007, assuming we drill the 76 wells currently budgeted. We estimate we will have an average working interest of 7.0%, and a net revenue interest of 6.0% in these 111 Integrated Wells.

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Our capital budget also calls for us to invest \$2.2 million with Alta in other onshore prospects in Texas, Louisiana, and Alabama.

Freeport LNG closed a \$383.0 million private placement note issuance in December 2005, and we believe the LNG project will continue through Phase I construction and Phase II pre-development expansion with no further significant funds being required from Contango.

As of August 31, 2006, we have approximately \$12.5 million in cash, cash equivalents, and short term investments. We have \$10.0 million in long-term debt outstanding and \$10.0 million of unutilized borrowing capacity available. The Company has estimated production during August 2006 of approximately 1.4 MMcfe/d.

*Income Taxes.* During the year ended June 30, 2006, we paid \$1.0 million in estimated income taxes, in large part related to the \$50.0 million sale of our onshore producing south Texas wells to Edge Petroleum Corporation.

**Off Balance Sheet Arrangements**

None.

**Contractual Obligations**

The following table summarizes our known contractual obligations as of June 30, 2006:

	Total	Payment due by period			More than 5 years
		Less than 1 year	1-3 years	3-5 years	
Long term debt	\$ 10,000,000	\$	\$ 10,000,000		\$
Operating leases	72,954	51,219	21,735		
<b>Total</b>	<b>\$ 10,072,954</b>	<b>\$ 51,219</b>	<b>\$ 10,021,735</b>	<b>\$</b>	<b>\$</b>

We intend to borrow the remaining \$10.0 million under our loan agreement with The Royal Bank of Scotland ( RBS ) at anytime prior to October 27, 2006. This additional borrowing will be due in April 2009.

**Long-Term Debt**

On April 27, 2006, the Company completed the arrangement of a new three-year \$20.0 million secured term loan agreement with RBS. The term loan agreement is secured with the stock of Contango Sundance, Inc. ( Sundance ), our wholly-owned subsidiary. Sundance owns a 10% limited partnership interest in Freeport LNG Development, LP, which owns the Freeport LNG facility. The Company has borrowed the first \$10.0 million under the term loan agreement and intends to borrow the remaining \$10.0 million at anytime prior to October 27, 2006. Borrowings under the term loan agreement bear interest, at the Company's option, at either (i) 30 day LIBOR, (ii) 60 day LIBOR, (iii) 90 day LIBOR or (iv) 6 month LIBOR, all plus 6.5%. Interest is due at the end of the LIBOR period chosen. The average interest rate charged as of June 30, 2006 was 11.69%. The principal is due April 27, 2009, but we may prepay after April 27, 2008 with no prepayment penalty. The term loan agreement required an arrangement fee of 2%, or \$400,000, which was paid upon closing.

The term loan agreement requires a minimum level of working capital, as defined in the term loan agreement. Additionally, the term loan agreement contains certain negative covenants that, among other things, restrict or limit our ability to incur indebtedness, sell certain assets, and pay dividends. Failure to maintain required working capital or comply with the term loan agreement's covenants could result in a default and acceleration of all indebtedness under the term loan agreement. As of June 30, 2006, the Company was in compliance with its financial covenants, ratios and other provisions of the term loan agreement.

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The Company also maintains a \$0.1 million credit facility with Guaranty Bank, FSB that matures on June 29, 2008. As of June 30, 2006 and June 30, 2005, the Company had no long term debt outstanding under the Guaranty Bank facility.

Any future borrowings under the Guaranty Bank facility will bear interest, at the Company's option, at either (i) LIBOR plus two percent (2%) or (ii) the bank's base rate plus one-fourth percent (1/4%) per annum. Additionally, the Company pays a quarterly commitment fee of three-eighths percent (3/8%) per annum on the average availability.

The hydrocarbon borrowing base under the Guaranty Bank facility is subject to semi-annual redetermination based primarily on the value of our proved reserves. The credit facility requires the maintenance of certain ratios, including those related to working capital and debt service coverage, as defined in the credit agreements. Additionally, the credit agreement contains certain negative covenants that, among other things, restrict or limit our ability to incur indebtedness, sell assets, pay dividends and reacquire or otherwise acquire or redeem capital stock. Failure to maintain required financial ratios or comply with the credit facility's covenants can result in a default and acceleration of all indebtedness under the credit facility and the inability to borrow under the facility. As of June 30, 2006, the Company was in compliance with its financial covenants, ratios and other provisions of its credit facility.

### **Application of Critical Accounting Policies and Management's Estimates**

The discussion and analysis of the Company's financial condition and results of operations is based upon the consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. The Company's significant accounting policies are described in Note 2 to the consolidated financial statements included in this Annual Report on Form 10-K. We have identified below the policies that are of particular importance to the portrayal of our financial position and results of operations and which require the application of significant judgment by management. The Company analyzes its estimates, including those related to oil and gas reserve estimates, on a periodic basis and bases its estimates on historical experience, independent third party reservoir engineers and various other assumptions that management believes to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. The Company believes the following critical accounting policies affect its more significant judgments and estimates used in the preparation of the Company's financial statements:

*Successful Efforts Method of Accounting.* Our application of the successful efforts method of accounting for our oil and gas business activities requires judgments as to whether particular wells are developmental or exploratory, since exploratory costs and the costs related to exploratory wells that are determined to not have proved reserves must be expensed whereas developmental costs are capitalized. The results from a drilling operation can take considerable time to analyze, and the determination that commercial reserves have been discovered requires both judgment and application of industry experience. Wells may be completed that are assumed to be productive and actually deliver oil and gas in quantities insufficient to be economic, which may result in the abandonment of the wells at a later date. On occasion, wells are drilled which have targeted geologic structures that are both developmental and exploratory in nature, and in such instances an allocation of costs is required to properly account for the results. Delineation seismic costs incurred to select development locations within a productive oil and gas field are typically treated as development costs and capitalized, but often these seismic programs extend beyond the proved reserve areas and therefore management must estimate the portion of seismic costs to expense as exploratory. The evaluation of oil and gas leasehold acquisition costs included in unproved properties requires management's judgment to estimate the fair value of exploratory costs related to drilling activity in a given area. Drilling activities in an area by other companies may also effectively condemn leasehold positions.

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*Reserve Estimates.* The Company's estimates of oil and gas reserves are, by necessity, projections based on geologic and engineering data, and there are uncertainties inherent in the interpretation of such data as well as the projection of future rates of production and the timing of development expenditures. Reserve engineering is a subjective process of estimating underground accumulations of oil and gas that are difficult to measure. The accuracy of any reserve estimate is a function of the quality of available data, engineering and geological interpretation and judgment. Estimates of economically recoverable oil and gas reserves and future net cash flows necessarily depend upon a number of variable factors and assumptions, such as historical production from the area compared with production from other producing areas, the assumed effect of regulations by governmental agencies, and assumptions governing future oil and gas prices, future operating costs, severance taxes, development costs and workover costs, all of which may in fact vary considerably from actual results. The future drilling costs associated with reserves assigned to proved undeveloped locations may ultimately increase to the extent that these reserves are later determined to be uneconomic. For these reasons, estimates of the economically recoverable quantities of expected oil and gas attributable to any particular group of properties, classifications of such reserves based on risk of recovery, and estimates of the future net cash flows may vary substantially. Any significant variance in the assumptions could materially affect the estimated quantity and value of the reserves, which could affect the carrying value of the Company's oil and gas properties and/or the rate of depletion of such oil and gas properties. Actual production, revenues and expenditures with respect to the Company's reserves will likely vary from estimates, and such variances may be material. Holding all other factors constant, a reduction in the Company's proved reserve estimate at June 30, 2006 of 1% would not have a material effect on DD&A expense.

*Impairment of Oil and Gas Properties.* The Company reviews its proved oil and gas properties for impairment on an annual basis or whenever events and circumstances indicate a potential decline in the recoverability of their carrying value. The Company compares expected undiscounted future net cash flows on a cost center basis to the unamortized capitalized cost of the asset. If the future undiscounted net cash flows, based on the Company's estimate of future natural gas and oil prices and operating costs and anticipated production from proved reserves, are lower than the unamortized capitalized cost, then the capitalized cost is reduced to fair market value. The factors used to determine fair value include, but are not limited to, estimates of reserves, future commodity pricing, future production estimates, anticipated capital expenditures, and a discount rate commensurate with the risk associated with realizing the expected cash flows projected. Unproved properties are reviewed quarterly to determine if there has been impairment of the carrying value, with any such impairment charged to expense in the period. Given the complexities associated with oil and gas reserve estimates and the history of price volatility in the oil and gas markets, events may arise that will require the Company to record an impairment of its oil and gas properties and there can be no assurance that such impairments will not be required in the future nor that they will not be material.

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**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Shareholders

Contango Oil & Gas Company

We have audited the accompanying consolidated balance sheets of Contango Oil & Gas Company (a Delaware corporation) and subsidiaries as of June 30, 2006 and 2005, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the three years in the period ended June 30, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Contango Oil & Gas Company and subsidiaries as of June 30, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2006 in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Contango Oil & Gas Company and subsidiaries' internal control over financial reporting as of June 30, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated September 8, 2006 expressed an unqualified opinion on management's assertion of the effectiveness of internal control over financial reporting and an unqualified opinion on the effectiveness of internal control over financial reporting.

GRANT THORNTON LLP

Houston, Texas

September 8, 2006

**Index to Financial Statements****CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****ASSETS**

	2006	June 30, 2005
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 10,274,950	\$ 3,985,775
Short-term investments	18,472,327	25,499,869
Inventory tubulars	194,825	
Accounts receivable:		
Trade receivable	481,593	1,423,094
Advances to affiliates	256,180	
Joint interest billings receivable	3,422,261	
Prepaid capital costs	1,208,299	
Other	202,583	302,926
<b>Total current assets</b>	<b>34,513,018</b>	<b>31,211,664</b>
<b>PROPERTY, PLANT AND EQUIPMENT:</b>		
Natural gas and oil properties, successful efforts method of accounting:		
Proved properties	18,395,015	4,666,048
Unproved properties	23,293,300	7,789,306
Furniture and equipment	231,877	197,949
Accumulated depreciation, depletion and amortization	(662,877)	(1,328,567)
<b>Total property, plant and equipment, net</b>	<b>41,257,315</b>	<b>11,324,736</b>
<b>OTHER ASSETS:</b>		
Cash and other assets held by affiliates	1,054,100	1,067,263
Investment in Freeport LNG Project	3,243,585	3,006,751
Investment in Contango Venture Capital Corporation	4,453,028	2,274,356
Deferred income tax asset	4,455,190	4,462,329
Facility fees and other assets	408,769	5,822
<b>Total other assets</b>	<b>13,614,672</b>	<b>10,816,521</b>
<b>TOTAL ASSETS</b>	<b>\$ 89,385,005</b>	<b>\$ 53,352,921</b>

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

**Index to Financial Statements****CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****LIABILITIES AND SHAREHOLDERS EQUITY**

	2006	June 30, 2005
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 1,041,505	\$ 435,661
Joint interest advances	5,638,600	
Accrued exploration and development	8,278,245	85,608
Advances from affiliates	194,862	
Income taxes payable		1,658,548
Other accrued liabilities	1,026,743	193,094
Total current liabilities	16,179,955	2,372,911
<b>LONG-TERM DEBT</b>	<b>10,000,000</b>	
<b>ASSET RETIREMENT OBLIGATION</b>	<b>665,458</b>	<b>957</b>
<b>SHAREHOLDERS EQUITY:</b>		
Convertible preferred stock, 6%, Series D, \$0.04 par value, 4,000 shares authorized, 2,000 shares issued and outstanding at June 30, 2006, liquidation preference of \$10,000,000 at \$5,000 per share	80	
Convertible preferred stock, 6%, Series C, \$0.04 par value, 4,000 shares authorized, 1,400 shares issued and outstanding at June 30, 2005, liquidation preference of \$7,000,000 at \$5,000 per share		56
Common stock, \$0.04 par value, 50,000,000 shares authorized, 17,574,085 shares issued and 14,999,085 outstanding at June 30, 2006, 15,997,809 shares issued and 13,422,809 outstanding at June 30, 2005,	702,961	639,910
Additional paid-in capital	45,105,504	32,800,077
Treasury stock at cost (2,575,000 shares)	(6,180,000)	(6,180,000)
Retained earnings	22,911,047	23,719,010
Total shareholders equity	62,539,592	50,979,053
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>\$ 89,385,005</b>	<b>\$ 53,352,921</b>

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



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## CONTANGO OIL &amp; GAS COMPANY AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended June 30,		
	2006	2005	2004
<b>REVENUES:</b>			
Natural gas and oil sales	\$ 920,304	\$ 1,088,933	\$ 106,651
Gain from hedging activities			58,171
Total revenues	920,304	1,088,933	164,822
<b>EXPENSES:</b>			
Operating expenses	13,350	19,683	90,336
Exploration expenses	8,202,385	5,870,066	6,365,430
Depreciation, depletion and amortization	232,702	352,114	40,817
Impairment of natural gas and oil properties	707,523	236,537	42,995
General and administrative expense	4,760,662	3,570,957	2,695,592
Total expenses	13,916,622	10,049,357	9,235,170
LOSS FROM CONTINUING OPERATIONS BEFORE OTHER INCOME AND INCOME TAXES	(12,996,318)	(8,960,424)	(9,070,348)
<b>OTHER INCOME (EXPENSE):</b>			
Interest expense (net of interest capitalized)	(54,488)	(71,506)	(362,127)
Interest income	826,399	431,803	38,182
Gain on sale of marketable securities			710,322
Gain on sale of assets and other	249,611	705,147	6,187,740
LOSS FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	(11,974,796)	(7,894,980)	(2,496,231)
Benefit for income taxes	4,248,623	2,748,121	932,174
LOSS FROM CONTINUING OPERATIONS	(7,726,173)	(5,146,859)	(1,564,057)
<b>DISCONTINUED OPERATIONS (Note 3)</b>			
Discontinued operations, net of income taxes	7,519,210	17,564,795	9,264,406
NET INCOME (LOSS)	(206,963)	12,417,936	7,700,349
Preferred stock dividends	601,000	420,000	620,000
NET INCOME (LOSS) ATTRIBUTABLE TO COMMON STOCK	\$ (807,963)	\$ 11,997,936	\$ 7,080,349
<b>NET INCOME (LOSS) PER SHARE:</b>			
Basic			
Continuing operations	\$ (0.56)	\$ (0.42)	\$ (0.20)
Discontinued operations	0.51	1.34	0.88
Total	\$ (0.05)	\$ 0.92	\$ 0.68

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Diluted				
Continuing operations	\$	(0.56)	\$	(0.42)
Discontinued operations		0.51		1.34
				0.88
Total	\$	(0.05)	\$	0.92
				0.68
<b>WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:</b>				
Basic		14,760,268		13,089,332
				10,484,078
Diluted		14,760,268		13,089,332
				10,484,078

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

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**Index to Financial Statements****CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	2006	Year Ended June 30, 2005	2004
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Loss from continuing operations	\$ (7,726,173)	\$ (5,146,859)	\$ (1,564,057)
Plus income from discontinued operations, net of income taxes	7,519,210	17,564,795	9,264,406
Net income (loss)	(206,963)	12,417,936	7,700,349
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation, depletion and amortization	1,199,436	2,815,982	6,989,428
Impairment of natural gas and oil properties	707,523	236,537	42,995
Exploration expenditures	8,221,045	4,875,506	6,073,120
Deferred income taxes	7,139	(3,273,922)	(533,605)
Gain on sale of assets and other	(7,232,351)	(16,993,441)	(7,882,026)
Unrealized hedging gain			(58,171)
Stock-based compensation	856,412	385,193	339,005
Tax benefit from exercise of stock options	(359,772)	591,226	86,778
Changes in operating assets and liabilities:			
Decrease in accounts receivable and other	947,586	3,341,701	1,272,822
Increase in prepaid insurance	(20,640)	(10,498)	(22,301)
Increase in inventory	(194,825)		
Increase (decrease) in accounts payable and advances from joint owners	6,219,698	(165,032)	(391,551)
Increase (decrease) in other accrued liabilities	792,025	(731,004)	11,652
(Decrease) increase in income taxes payable	(1,398,776)	1,417,790	(493,554)
Other	(64,921)	550	(15,218)
Net cash provided by operating activities	9,472,616	4,908,524	13,119,723
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Natural gas and oil exploration and development expenditures	(34,093,358)	(9,091,333)	(12,150,210)
Natural gas and oil exploration and development reimbursements, net of additions		1,461,053	
Decrease (increase) in net investment in affiliates	288,840	(287,902)	5,295
Investment in Freeport LNG Project	(236,834)	(673,418)	(1,483,333)
Sale (purchase) of short-term investments, net	7,027,542	(25,499,869)	
Additions to furniture and equipment	(20,425)	(16,412)	(58,120)
Decrease (increase) in advances to operators	1,137,056	(509,662)	157,350
Investment in Contango Venture Capital Corporation	(2,156,447)	(1,023,668)	(500,000)
Purchase of marketable equity securities			(375,000)
Proceeds from sales of marketable equity securities			1,761,822
Acquisition of overriding royalty interests	(1,000,000)		
Acquisition of Republic Exploration LLC and Contango Offshore Exploration LLC interests	(7,500,000)		
Sale/Acquisition costs	(7,170)	(168,686)	(5,281)
Proceeds from the sale of assets	12,892,916	40,131,428	7,766,379
Net cash provided (used) by investing activities	(23,667,880)	4,321,531	(4,881,098)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Borrowings under credit facility	10,000,000	2,200,000	22,229,028
Repayments under credit facility		(9,289,000)	(37,490,028)

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Proceeds from preferred equity issuances, net of issuance costs	9,616,438		7,554,614
Preferred stock dividends	(601,000)	(420,000)	(620,000)
Repurchase/cancellation of stock options and warrants			(757,498)
Proceeds from exercise of options and warrants	1,535,880	1,888,167	1,075,769
Tax benefit from exercise of stock options	359,772		
Debt issue costs	(426,651)	(20,200)	(52,999)
Net cash provided (used) in financing activities	20,484,439	(5,641,033)	(8,061,114)
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>6,289,175</b>	<b>3,589,022</b>	<b>177,511</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>3,985,775</b>	<b>396,753</b>	<b>219,242</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 10,274,950</b>	<b>\$ 3,985,775</b>	<b>\$ 396,753</b>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>			
Cash paid for taxes	\$ 1,045,816	\$ 7,974,387	\$ 4,781,239
Cash paid for interest	\$ 125,582	\$ 83,696	\$ 386,743

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

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## CONTANGO OIL &amp; GAS COMPANY AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

	Preferred Stock		Common Stock		Paid-in Capital	Treasury Stock	Retained Earnings	Total Shareholders Equity
	Shares	Amount	Shares	Amount				
<b>Balance at June 30, 2003</b>	7,500	\$ 300	9,296,076	\$ 473,399	\$ 21,803,090	\$ (6,180,000)	\$ 4,640,725	\$ 20,737,514
Exercise of stock options and warrants			518,750	20,750	1,055,019			1,075,769
Tax benefit from exercise of stock options					86,778			86,778
Expense of stock options					339,005			339,005
Cashless exercise of stock options and warrants			359,510	15,824	(15,824)			
Repurchase/cancellation of stock options and warrants					(757,498)			(757,498)
Conversion of Series A preferred stock and Series B preferred stock to common stock	(7,500)	(300)	2,136,364	85,455	(85,155)			
Issuance of Series C preferred stock	1,600	64			7,554,550			7,554,614
Net income							7,700,349	7,700,349
Preferred stock dividends							(620,000)	(620,000)
<b>Balance at June 30, 2004</b>	1,600	\$ 64	12,310,700	\$ 595,428	\$ 29,979,965	\$ (6,180,000)	\$ 11,721,074	\$ 36,116,531
Exercise of stock options and warrants			747,584	29,902	1,858,265			1,888,167
Tax benefit from exercise of stock options					591,226			591,226
Cashless exercise of stock options and warrants			197,859	7,913	(7,913)			
Partial conversion of Series C preferred stock to common stock	(200)	(8)	166,666	6,667	(6,659)			
Expense of stock options					385,193			385,193
Net income							12,417,936	12,417,936
Preferred stock dividends							(420,000)	(420,000)
<b>Balance at June 30, 2005</b>	1,400	\$ 56	13,422,809	\$ 639,910	\$ 32,800,077	\$ (6,180,000)	\$ 23,719,010	\$ 50,979,053
Exercise of stock options and warrants			406,500	16,260	1,519,620			1,535,880
Tax benefit from exercise of stock options					359,772			359,772
Cashless exercise of stock options			3,114	125	(125)			
Conversion of Series C preferred stock to common stock	(1,400)	(56)	1,166,662	46,666	(46,610)			
Issuance of Series D preferred stock	2,000	80			9,616,358			9,616,438
Expense of stock options					856,412			856,412
Net loss							(206,963)	(206,963)
Preferred stock dividends							(601,000)	(601,000)

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<b>Balance at June 30, 2006</b>	2,000	\$	80	14,999,085	\$	702,961	\$	45,105,504	\$	(6,180,000)	\$	22,911,047	\$	62,539,592
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The accompanying notes are an integral part of these consolidated financial statements.

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**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Organization and Business**

Contango is a Houston-based, independent natural gas and oil company. The Company's core business is to explore, develop, produce and acquire natural gas and oil properties primarily offshore in the Gulf of Mexico and in the Arkansas Fayetteville Shale. Contango Operators, Inc. (COI), a wholly-owned subsidiary, acts as operator on certain offshore prospects. The Company also owns a 10% interest in a limited partnership formed to develop a liquefied natural gas (LNG) receiving terminal in Freeport, Texas, and holds investments in companies focused on commercializing environmentally preferred energy technologies.

**2. Summary of Significant Accounting Policies**

The application of generally accepted accounting principles involves certain assumptions, judgments, choices and estimates that affect reported amounts of assets, liabilities, revenues and expenses. Thus, the application of these principles can result in varying results from company to company. Contango's critical accounting principles, which are described below, relate to the successful efforts method for costs related to natural gas and oil activities, consolidation principles and stock based compensation, cash and cash equivalents, and short-term investments.

*Reclassifications.* Certain reclassifications have been made to the 2005 and 2004 financial statements to conform to the 2006 presentation. These reclassifications related to discontinued operations and have no impact on previously reported net income or cash flows.

*Use of Estimates.* The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. Significant estimates with regard to these financial statements include the estimate of proved natural gas and oil reserve quantities and the related present value of estimated future net cash flows therefrom (see Supplemental Oil and Gas Disclosures) and the mark to market valuation of the Fund (see Note 9 Contango Venture Capital Corporation).

*Revenue Recognition.* Revenues from the sale of natural gas and oil produced are recognized upon the passage of title, net of royalties. Revenues from natural gas production are recorded using the sales method. When sales volumes exceed the Company's entitled share, an overproduced imbalance occurs. To the extent the overproduced imbalance exceeds the Company's share of the remaining estimated proved natural gas reserves for a given property, the Company records a liability. At June 30, 2006 and 2005, the Company had no overproduced imbalances.

*Cash Equivalents.* Cash equivalents are considered to be highly liquid investment grade debt investments having an original maturity of 90 days or less. As of June 30, 2006, the Company had \$10,274,950 in cash and cash equivalents, of which \$6,416,527 was invested in highly liquid AAA-rated tax-exempt money market funds. Cash equivalents are considered to be all highly liquid debt investments having an original maturity of three months or less. As of June 30, 2005, the Company had cash and cash equivalents of \$3,985,775.

*Short Term Investments.* As of June 30, 2006, the Company had \$18,472,327 invested in a portfolio of periodic auction reset (PAR) securities, which have coupons that periodically reset to market interest rates at intervals ranging from 7 to 35 days. These PAR securities are being classified as short term investments and consist of AAA-rated tax-exempt municipal bonds. PAR securities are highly liquid and have minimal interest rate risk.

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**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

*Accounts Receivable.* The Company sells crude oil and natural gas to various customers. In addition, the Company participates with other parties in the operation of crude oil and natural gas wells. Substantially all of the Company's accounts receivable are due from either purchasers of crude oil and natural gas or participants in crude oil and natural gas wells for which the Company serves as the operator. Generally, operators of crude oil and natural gas properties have the right to offset future revenues against unpaid charges related to operated wells. Crude oil and natural gas sales are generally unsecured.

The allowance for doubtful accounts is an estimate of the losses in the Company's accounts receivable. The Company periodically reviews the accounts receivable from customers for any collectability issues. An allowance for doubtful accounts is established based on reviews of individual customer accounts, recent loss experience, current economic conditions, and other pertinent factors. Accounts deemed uncollectible are charged to the allowance. Provisions for bad debts and recoveries on accounts previously charged-off are added to the allowance.

Accounts receivable allowance for bad debt was \$0 at June 30, 2006 and 2005. At June 30, 2006 and 2005, the carrying value of the Company's accounts receivable approximates fair value.

*Impairment of Long-Lived Assets.* The Company follows Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144), which requires impairment losses to be recorded on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the asset's carrying amount. In the evaluation of the fair value and future benefits of long-lived assets, the Company performs an analysis of the anticipated undiscounted future net cash flows of the related long-lived assets. If the carrying value of the related asset exceeds the undiscounted cash flows, the carrying value is reduced to its fair value.

*Net Income (Loss) per Common Share.* Basic and diluted net income (loss) per common share have been computed in accordance with SFAS No. 128, Earnings per Share. Basic net income (loss) per common share is computed by dividing income (loss) attributable to common stock by the weighted average number of common shares outstanding for the period. Diluted net income per common share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. See Note 4 Net Income (Loss) Per Common Share for the calculations of basic and diluted net income (loss) per common share.

*Income Taxes.* The Company follows the liability method of accounting for income taxes under which deferred tax assets and liabilities are recognized for the future tax consequences of (i) temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements and (ii) operating loss and tax credit carryforwards for tax purposes. Deferred tax assets are reduced by a valuation allowance when, based upon management's estimates, it is more likely than not that a portion of the deferred tax assets will not be realized in a future period.

*Concentration of Credit Risk.* Substantially all of the Company's accounts receivable result from natural gas and oil sales or joint interest billings to a limited number of third parties in the natural gas and oil industry. This concentration of customers and joint interest owners may impact the Company's overall credit risk in that these entities may be similarly affected by changes in economic and other conditions.

*Consolidated Statements of Cash Flows.* For the purpose of cash flows, the Company considers all highly liquid investments with a maturity date of three months or less when purchased to be cash equivalents. Significant transactions may occur that do not directly affect cash balances and, as such, are not disclosed in the Consolidated Statements of Cash Flows. Certain such non-cash transactions are disclosed in the Consolidated Statements of Shareholders' Equity, including shares issued as compensation and issuance of stock options.

*Fair Value of Financial Instruments.* The carrying amounts of the Company's short-term financial instruments, including cash equivalents, short-term investments, trade accounts receivable and trade accounts



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**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

payable, approximate their fair values based on the short maturities of those instruments. The Company's long-term debt was variable rate debt and, as such, approximated fair value, as interest rates are variable based on prevailing market rates.

*Successful Efforts Method of Accounting.* The Company follows the successful efforts method of accounting for its natural gas and oil activities. Under the successful efforts method, lease acquisition costs and all development costs are capitalized. Unproved properties are reviewed quarterly to determine if there has been impairment of the carrying value, and any such impairment is charged to expense in the period. Exploratory drilling costs are capitalized until the results are determined. If proved reserves are not discovered, the exploratory drilling costs are expensed. Other exploratory costs, such as seismic costs and other geological and geophysical expenses, are expensed as incurred. The provision for depreciation, depletion and amortization is based on the capitalized costs as determined above. Depreciation, depletion and amortization is on a cost center by cost center basis using the unit of production method, with lease acquisition costs amortized over total proved reserves and other costs amortized over proved developed reserves.

When circumstances indicate that proved properties may be impaired, the Company compares expected undiscounted future cash flows on a cost center basis to the unamortized capitalized cost of the asset. If the future undiscounted cash flows, based on the Company's estimate of future natural gas and oil prices and operating costs and anticipated production from proved reserves, are lower than the unamortized capitalized cost, then the capitalized cost is reduced to fair market value.

On July 1, 2003, the Company changed its accounting policy for amortizing and impairing the Company's natural gas and oil properties from a well-by-well cost center basis to a field-by-field cost center basis. Management believes this policy is preferable in providing greater comparability with other successful efforts natural gas and oil companies by conforming to predominant industry practice. In addition, the field level is consistent with the Company's operational and strategic assessment of its natural gas and oil investments. The Company determined that the cumulative effect of the change in accordance with APB Opinion No. 20 was immaterial to the consolidated financial statements.

In accordance with SFAS 144, the Company classified its \$11.6 million property sale effective April 1, 2006, its property sale to an independent oil and gas company for \$2.0 million, effective February 1, 2006, and its property sale to Edge Petroleum Corporation ( Edge Petroleum ) for \$50.0 million, effective July 1, 2004, as discontinued operations. An integral and on-going part of our business strategy is to sell our proved reserves from time to time in order to generate additional capital to reinvest in our onshore and offshore exploration programs. Thus, it is our intent to remain an independent natural gas and oil company engaged in the exploration, production, and acquisition of natural gas and oil.

*Principles of Consolidation.* The Company's consolidated financial statements include the accounts of Contango Oil & Gas Company and its subsidiaries and affiliates, after elimination of all intercompany balances and transactions. Wholly-owned subsidiaries are fully consolidated. Exploration and development subsidiaries not wholly owned, such as 42.7% owned REX, 50% owned MOE, and 76.0% owned COE, each as of June 30, 2006, are not controlled by the Company and are proportionately consolidated.

Upon the formation of REX and MOE, Contango was the only owner that contributed cash, and under the terms of the respective limited liability company agreements, was entitled to all of the ventures' assets and liabilities until the ventures expended all of the Company's initial cash contribution. The Company therefore consolidated 100% of the ventures' net assets and results of operations. During the quarter ended December 31, 2002, both REX and MOE completed exploration activities to fully expend the Company's initial cash contribution, thereby enabling each owner to share in the net assets of the venture based on their stated ownership percentages. Commencing with the quarter ended December 31, 2002, the Company began consolidating 33.3% and 50.0% of the net assets and results of operations of REX and MOE, respectively. The reduction of our ownership in the net assets of REX and MOE resulted in a non-cash exploration expense of approximately \$4.2 million and \$0.2 million, respectively. The other owners of REX contributed seismic data and related geological and geophysical services, while the other owner of MOE contributed geological and geophysical services in exchange for its ownership interest.

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**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

Upon the formation of COE, Contango was the only owner that contributed cash, but by agreement, the owners in COE immediately shared in the net assets of COE, including the Company's initial cash contribution, based on their stated ownership percentages. The Company therefore consolidated 66.6% of the venture's net assets and results of operations. The other owner of COE contributed geological and geophysical services in exchange for its ownership interest.

On September 2, 2005, the Company purchased an additional 9.4% ownership interest in each of REX and COE. Both interests were purchased from an existing owner, which prior to the sale, owned 33.3% of each of the two subsidiaries. As a result of these two purchases, the Company's equity ownership interest in REX has increased from 33.3% to 42.7% and in COE from 66.6% to 76.0%. On September 2, 2005, an independent third party also purchased a 9.4% interest in each of REX and COE and the selling owner's ownership interest thus decreased from 33.3% to 14.6% in each such entity.

Contango's 10% limited partnership interest in Freeport LNG Development, L.P. (Freeport LNG) is accounted for at cost. As a 10% limited partner, the Company has no ability to direct or control the operations or management of the general partner.

Contango's 32% ownership in Contango Capital Partnership Management, LLC (CCPM) and Contango's 25% limited partnership interest in Contango Capital Partners, L.P. (CCPLP) are accounted for using the equity method. Under the equity method, only Contango's investment in and amounts due to and from the equity investee are included in the consolidated balance sheet. CCPLP formed the Contango Capital Partners Fund, LP (the Fund) in January 2005. The Fund owns equity interests in a portfolio of alternative energy companies. The Fund marks these equity interests to market according to fair market values on a quarterly basis.

Contango's investments in Trulite, Inc. (Trulite), Mobilize, Inc. (Mobilize) and Gridpoint, Inc. (Gridpoint) are accounted for using the cost method. Under the cost method, Contango records an investment in the stock of an investee at cost, and recognizes dividends received as income. Dividends received in excess of earnings subsequent to the date of investment are considered a return of investment and are recorded as reductions of cost of the investment.

*Recent Accounting Pronouncements.* In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation 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. It 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 interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the provisions of FIN 48 and assessing the impact, if any, it may have on our financial position and results of operations.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154), which replaces Accounting Principles Board Opinions No. 20 Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements-An Amendment of APB Opinion No. 28. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS 154 is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005, and was adopted by the Company in the first quarter of 2006.

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## CONTANGO OIL &amp; GAS COMPANY AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

*Stock-Based Compensation.* Effective July 1, 2001, the Company adopted the fair value based method prescribed in SFAS No. 123, *Accounting for Stock Based Compensation* ( SFAS 123 ). Under the fair value based method, compensation cost is measured at the grant date based on the fair value of the award and is recognized over the award vesting period. The fair value of each award is estimated as of the date of grant using the Black-Scholes options-pricing model. Effective July 1, 2005, the Company adopted SFAS No. 123 (revised 2004) ( SFAS 123(R) ),

*Share-Based Payment* . Prior to the adoption of SFAS 123(R), the Company presented all benefits from the exercise of share-based compensation as operating cash flows in the statement of cash flows. SFAS 123(R) requires the benefits of tax deductions in excess of the compensation cost recognized for the options (excess tax benefit) to be classified as financing cash flows. The fair value of each option is estimated as of the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants during the years ended June 30, 2006, 2005 and 2004, respectively: (i) risk-free interest rate of 5.1 percent, 3.68 percent and 3.88 percent, respectively; (ii) expected lives of five years; (iii) expected volatility of 40 percent, 40 percent and 26 percent, respectively; and (iv) expected dividend yield of zero percent.

During the years ended June 30, 2006, 2005 and 2004, the Company recorded a charge of \$856,412, \$385,193 and \$339,005 in stock option expenses to general and administrative expense, respectively.

*Derivative Instruments and Hedging Activities.* The Company did not enter into any derivative instruments or hedging activities for the fiscal year ended June 30, 2006 or June 30, 2005, nor did we have any open commodity derivative contracts at June 30, 2006.

Contango previously has entered into commodity derivatives contracts and fixed-price physical contracts with investment grade companies to manage its exposure to natural gas and oil price volatility. These took the form of futures contracts, swaps and options. For the year ended June 30, 2004, the Company recognized a gain from hedging activities of \$58,171. Although the Company's hedging transactions were designed as economic hedges for a portion of future natural gas and oil production, the Company elected not to designate the derivative instruments as hedges under SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities* . As a result, changes in these derivative instruments mark-to-market fair values were recognized in the Company's earnings.

*Marketable Equity Securities.* As part of the formation of Freeport LNG Development, L.P., Cheniere Energy, Inc. ( Cheniere ) granted Contango warrants to purchase 300,000 shares of Cheniere common stock. In June and September 2003, Contango exercised the warrants, purchasing 300,000 shares of Cheniere common stock. All of the Company's marketable securities related to an investment in Cheniere common stock, were sold in fiscal year 2004 resulting in a gain of \$710,322 recognized under *Gain on Sale of Marketable Securities* .

*Asset Retirement Obligation.* The Company adopted SFAS No. 143, *Accounting for Asset Retirement Obligations* , ( SFAS 143 ), as of July 1, 2002. SFAS 143 requires the Company to record the fair value of a liability for an asset retirement obligation ( ARO ) in the period in which it is incurred. When the liability is initially recorded, a company increases the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, an entity either settles the obligation for its recorded amount or incurs a gain or loss upon settlement. Due to the Company's focus on offshore properties during the year, the ARO has significantly increased. Activities related to the Company's ARO during the year ended June 30, 2006 and 2005 are as follows:

	<b>Year Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
Initial ARO as of July 1	\$ 957	\$ 84,805
Liabilities incurred during period	665,458	2,336
Liabilities settled during period	(1,277)	(87,839)
Accretion expense	320	1,655
Balance of ARO as of June 30	\$ 665,458	\$ 957



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**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

*Capitalized Exploratory Well Costs.* As of June 30, 2006, the Company has capitalized exploratory well costs of \$10.4 million that is pending final determination of proved reserves.

**3. Sale of Properties Discontinued Operations**

On March 24, 2006, the Company's Board of Directors approved the sale of all of the Company's onshore producing assets in Texas and Alabama for an aggregate purchase price of \$11.6 million. These properties were held by Contango STEP, LP (STEP), an indirect wholly-owned subsidiary of the Company. On April 28, 2006, the Company completed the sale of substantially all of these natural gas and oil interests for \$11.1 million pursuant to a purchase and sale agreement. The sale of the remaining two wells under the same purchase and sale agreement for an aggregate purchase price of approximately \$0.5 million was completed in June 2006. The sold properties had net reserves of approximately 203 thousand barrels (Mbbbl) of oil and 849 million cubic feet (MMcf) of gas, or 2.1 billion cubic feet equivalent (Bcfe). The Company recognized a pre-tax gain of \$6.2 million for the year ended June 30, 2006. This sale has been classified as discontinued operations in our financial statements for all periods presented.

In March 2006, the Company completed the sale of its interest in a producing well in Zapata County, Texas to an independent oil and gas company for approximately \$2.0 million. Approximately 227 MMcf of proven reserves were sold. Pre-tax proceeds after netting adjustments were \$2.0 million. The Company recognized a pre-tax gain on sale of \$1.0 million for the year ended June 30, 2006. This sale has been classified as discontinued operations in our financial statements for all periods presented.

In December 2004, the Company sold producing properties consisting of 39 wells in south Texas, a majority of our natural gas and oil interests, to Edge Petroleum Corporation for \$50.0 million. The sale was approved by a majority of the Company's stockholders at a Special Meeting of Stockholders on December 29, 2004. Approximately 16 billion cubic feet per day equivalent (Bcfe/d) of proven reserves were sold having a pre-tax net present value when using a 10% discount rate as of June 30, 2004 of \$54.3 million. Pre-tax proceeds after netting adjustments were \$40.1 million. Adjustments were made for net revenues that Contango received for production occurring after July 1, 2004, the effective date of sale, up to the post-closing date of March 29, 2005. The Company recognized a gain on sale of \$16.3 million for the year ended June 30, 2005. Our sale of assets to Edge Petroleum has been classified as discontinued operations in our financial statements for all periods presented.

In September 2003, the Company completed the sale of certain reserves in Brooks County, Texas for \$5.0 million and recorded a gain of approximately \$1.0 million for the year ended June 30, 2004. Proved reserves were 1.5 Bcfe. The sale of the Brooks County reserves was reclassified as discontinued operations since these reserves were part of our original south Texas natural gas and oil interests.

In accordance with SFAS 144, we classified our property sales as discontinued operations in our financial statements for all periods presented.

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The summarized financial results for discontinued operations for each of the periods ended June 30 are as follows:

**Operating Results:**

	2006	June 30, 2005	2004
Revenues	\$ 4,874,091	\$ 15,177,774	\$ 27,523,162
Operating (expenses) credits *	1,520,269	(1,215,544)	(3,797,848)
Depreciation expenses	(966,734)	(2,463,868)	(6,948,611)
Exploration expenses	(1,092,741)	(763,894)	(3,507,734)
Gain on sale of discontinued operations	7,233,130	16,288,294	983,964
Gain before income taxes	\$ 11,568,015	\$ 27,022,762	\$ 14,252,933
Provision for income taxes	(4,048,805)	(9,457,967)	(4,988,527)
Gain from discontinued operations, net of income taxes	\$ 7,519,210	\$ 17,564,795	\$ 9,264,406

\* Credits due to severance tax refunds

For the year ended June 30, 2006, operating expenses from discontinued operations resulted in a net credit of \$1,520,269. The credit was attributable to credits issued for previously paid severance taxes. The Railroad Commission of Texas allows for a severance tax reduction on tight sand gas wells. As a result, some of our former south Texas formation properties, which were included in the sale of our south Texas natural gas and oil interests to Edge Petroleum, were eligible for severance tax reduction. By contractual agreement, revenues and expenses prior to July 1, 2004, the effective date of the sale, accrue to us.

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## CONTANGO OIL &amp; GAS COMPANY AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

**4. Net Income (Loss) Per Common Share**

A reconciliation of the components of basic and diluted net income (loss) per common share for the fiscal years ended June 30, 2006, 2005 and 2004 is presented below:

	Year Ended June 30, 2006		
	Net		Per
	Income (Loss)	Shares	Share
Loss from continuing operations including preferred dividends	\$ (8,327,173)	14,760,268	\$ (0.56)
Discontinued operations, net of income taxes	7,519,210	14,760,268	0.51
<b>Basic Earnings per Share:</b>			
Net loss	\$ (807,963)	14,760,268	\$ (0.05)
Effect of Potential Dilutive Securities:			
Stock options and warrants		(a)	
Series C preferred stock	(a)	(a)	
Series D preferred stock	(a)	(a)	
Loss from continuing operations	\$ (8,327,173)	14,760,268	\$ (0.56)
Discontinued operations, net of income taxes	7,519,210	14,760,268	0.51
<b>Diluted Earnings per Share:</b>			
Net loss	\$ (807,963)	14,760,268	\$ (0.05)
Anti-dilutive Securities:			
Shares assumed not issued from options to purchase common shares as income from continuing operations was in a loss position for the period	\$	927,500	\$ 7.78
Series D Preferred Stock	\$ 601,000	833,330	\$ 0.72
Series C Preferred Stock	\$ 21,000	1,166,667	\$ 0.02
(a) Anti-dilutive.			

	Year Ended June 30, 2005		
	Net		Per
	Income (Loss)	Shares	Share
Loss from continuing operations including preferred dividends	\$ (5,566,859)	13,089,332	\$ (0.42)
Discontinued operations, net of income taxes	17,564,795	13,089,332	1.34
<b>Basic Earnings per Share:</b>			
Net income	\$ 11,997,936	13,089,332	\$ 0.92

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Effect of Potential Dilutive Securities:

Stock options and warrants			(a)
Series C preferred stock		(a)	(a)
Loss from continuing operations	\$ (5,566,859)	13,089,332	\$ (0.42)
Discontinued operations, net of income taxes	17,564,795	13,089,332	1.34

**Diluted Earnings per Share:**

Net income	\$ 11,997,936	13,089,332	\$ 0.92
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Anti-dilutive Securities:

Shares assumed not issued from options to purchase common shares as income from continuing operations was in a loss position for the period	\$	1,301,000	\$ 6.38
Series C Preferred Stock	\$ 420,000	1,166,667	\$ 0.36

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## CONTANGO OIL &amp; GAS COMPANY AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## 4. Net Income (Loss) Per Common Share continued

	Year Ended June 30, 2004		
	Net		Per
	Income (Loss)	Shares	Share
Loss from continuing operations including preferred dividends	\$ (2,184,057)	10,484,078	\$ (0.20)
Discontinued operations, net of income taxes	9,264,406	10,484,078	0.88
<b>Basic Earnings per Share:</b>			
Net income	\$ 7,080,349	10,484,078	\$ 0.68
Effect of Potential Dilutive Securities:			
Stock options and warrants		(a)	
Series A preferred stock	(a)	(a)	
Series B preferred stock	(a)	(a)	
Series C preferred stock	(a)	(a)	
Loss from continuing operations	\$ (2,184,057)	10,484,078	\$ (0.20)
Discontinued operations, net of income taxes	9,264,406	10,484,078	0.88
<b>Diluted Earnings per Share:</b>			
Net income	\$ 7,080,349	10,484,078	\$ 0.68
Anti-dilutive Securities:			
Shares assumed not issued from options to purchase common shares as income from continuing operations was in a loss position for the period	\$	1,966,521	\$ 3.66
Series A Preferred Stock	\$ 117,777	592,896	\$ 0.20
Series B Preferred Stock	\$ 235,556	673,746	\$ 0.35
Series C Preferred Stock	\$ 266,667	733,330	\$ 0.36

(a) Anti-dilutive.

## 5. Acquisition of Interest in Partially-Owned Subsidiaries and Overriding Royalties

On September 2, 2005, we purchased an additional 9.4% ownership interest in each of our two partially-owned offshore Gulf of Mexico exploration subsidiaries, REX for \$5.6 million and COE for \$1.9 million, for a total expenditure of \$7.5 million. Both interests were purchased from Juneau Exploration, L.P. ( JEX ), which prior to the sale, owned 33.3% of each of the two subsidiaries. As a result of these two purchases, the Company's equity ownership interest in REX has increased from 33.3% to 42.7% and in COE from 66.6% to 76.0%. The purchases were financed from the Company's existing cash on hand. An independent third party also purchased a 9.4% interest in each of REX and COE from JEX for the same total purchase price of \$7.5 million. JEX will continue in its capacity as the managing member of both REX and COE and following these two sales, now owns a 14.6% interest in each of REX and COE.

During the year ended June 30, 2006, the Company allocated the purchase price to the net assets acquired ( purchase price allocation ). These assets include planned drilling commitments, unevaluated exploration blocks, and proven developed producing ( PDP ) properties. A significant portion of the purchase price allocation was allocated to our Eugene Island 10 ( Dutch ) exploration prospect. Should Dutch not be successful, the Company will be required under successful efforts accounting to expense all or a portion of this allocation in addition to the drilling costs.

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During the year ended June 30, 2006, we wrote off \$0.3 million of the purchase price relating to our Main Pass 221 prospect and \$0.3 million relating to our West Delta 43 prospect, because they were dry holes; and \$0.1 million relating to our East Cameron 107 prospect, as a result of the expiration of its lease.

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**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

On November 7, 2005, the Company, in a separate transaction, also acquired certain overriding royalty interests in REX, COE and MOE offshore prospects for the purchase price of \$1.0 million.

**6. Series D Perpetual Cumulative Convertible Preferred Stock**

On July 15, 2005, we sold \$10.0 million of our Series D preferred stock to a group of private investors. The Series D preferred stock is perpetual and cumulative, is senior to our common stock and is convertible at any time into shares of our common stock at a price of \$12.00 per share. Each record holder of Series D preferred stock is entitled to one vote per share for each share of common stock into which each share of Series D preferred stock is convertible. The dividend on the Series D preferred stock can be paid quarterly in cash at a rate of 6.0% per annum or paid-in-kind at a rate of 7.5% per annum. Our registration statement filed with the Securities and Exchange Commission, covering the 833,330 shares of common stock issuable upon conversion of the Series D preferred stock, became effective on October 26, 2005. Net proceeds associated with the private placement of the Series D preferred stock was \$9,616,358, net of stock issuance costs.

**7. Conversion of Series C Cumulative Convertible Preferred Stock into Common Stock**

On July 1, 2004, private institutional investors elected to convert 200 of the 1,600 shares of the Company's Series C cumulative convertible preferred stock into 166,666 shares of Contango common stock.

On July 19, 2005, we exercised our mandatory conversion rights pursuant to the terms of our Series C preferred stock, and converted all of the remaining 1,400 shares of our Series C preferred stock issued and outstanding into 1,166,662 shares of common stock. The outstanding shares of the Series C preferred stock had a face value of \$7.0 million, and paid a 6.0% per annum quarterly cash dividend.

Holders of the Company's common stock are entitled to one vote per share on all matters to be voted on by shareholders and are entitled to receive dividends, if any, as may be declared from time to time by the Board of Directors of the Company. Holders of common stock and holders of Series D preferred stock vote as one class for the election of directors and most other matters. Upon any liquidation or dissolution of the Company, the holders of common stock are entitled to receive a pro rata share of all of the assets remaining available for distribution to shareholders after settlement of all liabilities and liquidating preferences of preferred stockholders.

**8. Investment in Freeport LNG**

As of June 30, 2006, the Company has invested \$3.2 million and owns a 10% limited partnership interest in Freeport LNG, a limited partnership formed to develop a 1.5 billion cubic feet per day ( Bcf/d ) liquefied natural gas ( LNG ) receiving terminal in Freeport, Texas.

In July 2004, Freeport LNG finalized its transaction with ConocoPhillips for the financing, construction and use of the LNG receiving terminal in Freeport, Texas. ConocoPhillips executed a terminal use agreement for 1.0 Bcf/d of regasification capacity, purchased a 50% interest in the general partner managing the Freeport LNG project and agreed to provide construction funding to the venture. This construction funding will be non-recourse to Contango. The Dow Chemical Company has also executed a terminal use agreement for regasification capacity of 500 million cubic feet per day ( MMcf/d ) and, in an unrelated transaction with another limited partner, has purchased a 15% limited partnership interest in Freeport LNG. Freeport LNG is responsible for the commercial activities of the partnership, while ConocoPhillips, under a construction advisory and management agreement, is managing the construction of the facility.

In January 2005, Freeport LNG received its authorization to commence construction of the first phase of its terminal from the Federal Energy Regulatory Commission (the FERC ) and construction of the 1.5 Bcf/day facility commenced on January 17, 2005. The engineering, procurement and construction contractor is a consortium of Technip USA, Zachry Construction of San Antonio, and Saipem SpA of Italy.

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CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

**9. Contango Venture Capital Corporation**

As of June 30, 2006, Contango Venture Capital Corporation ( CVCC ), our wholly-owned subsidiary, held a direct investment in the three alternative energy portfolio companies described below. Our investment in these companies is less than 20% and we account for these investments under the cost method.

*Trulite, Inc.* As of June 30, 2006, CVCC had invested \$0.9 million in Trulite, Inc. ( Trulite ) in exchange for 2,001,014 shares of Trulite common stock, which represents an approximate 17% ownership interest. Trulite develops lightweight hydrogen generators for fuel cell systems.

*Moblize Inc.* As of June 30, 2006, CVCC had invested \$0.6 million in Moblize Inc. ( Moblize ) in exchange for 324,324 shares of Moblize convertible preferred stock, which represents an approximate 19 % ownership interest. Moblize develops real time diagnostics and field optimization solutions for the oil and gas industry using open-standards based technologies. Moblize is deploying its technology in oil fields near Houston belonging to Chevron U.S.A. Inc.

*Gridpoint, Inc.* In May 2006, CVCC invested \$1.0 million in Gridpoint, Inc. ( Gridpoint ) in exchange for 333,333 shares of Gridpoint preferred stock, which represents an approximate 3% ownership interest. Gridpoint s intelligent energy management (IEM) products ensure clean, reliable power, increase energy efficiency, and integrate renewable energy. With Gridpoint, home and business owners can automatically protect themselves from power outages, manage their energy online and reduce their carbon footprint. Gridpoint s plug-and-play appliances are easy to install and are sold through a network of premium home builders, utilities, retail chains and government entities as well as installers and contractors of electrical, heating, air-conditioning, home automation, power quality and renewable energy systems.

In June 2004, CVCC acquired a 32% membership interest in Contango Capital Partnership Management, LLC ( CCPM ) for \$0.5 million. CCPM was formed by us and other investors to invest in the energy venture capital market. CVCC is the 25% limited partner of, and CCPM is the general partner of, Contango Capital Partners, L.P., which was formed in January 2005 for the purpose of investing in the energy venture capital market. Contango Capital Partners, L.P. then formed Contango Capital Partners Fund, L.P. (the Fund ).

On January 31, 2005, the Fund was closed to new investments with a total capitalization of \$8.2 million in the form of contributed stock, cash, and future cash commitments. Prior to CVCC holding a direct interest in Trulite and Moblize, the Fund previously held these investments. The Fund also had an investment in Synexus Energy, Inc. ( Synexus ). Synexus is a portable and stationary fuel cell integrator developing technology with a lightweight fuel cell stack that will create both portable and stationary power solutions for customers.

During the year ended June 30, 2006, the Fund invested an additional \$0.8 million in Trulite, \$0.6 million in Moblize, and an additional \$1.0 million in Synexus. In April 2006, Trulite acquired Synexus technology. In May 2006, the Fund distributed its pro rata shares of Trulite to CVCC. In June 2006, the Fund sold its investment in Moblize to CVCC for \$0.6 million.

As of June 30, 2006, CVCC owns 25% of the Fund. The Fund currently holds a direct investment in two alternative energy companies Protonex Technology Corporation ( Protonex ) and Jadoo Power Systems ( Jadoo ). We account for our investment in the Fund under the equity method. The Fund, however, accounts for its investment in Protonex in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities , and accounts for its investment in Jadoo at fair value in accordance with the AICPA Audit and Accounting Guide, Investment Companies . CCPM is the general partner of the Fund.

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## CONTANGO OIL &amp; GAS COMPANY AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

*Protonex Technology Corporation.* To date, the Fund has invested \$1.5 million in Protonex Technology Corporation ( Protonex ) in exchange for 2,400,000 shares of Protonex stock, which represents an approximate 7% ownership interest. Protonex provides long-duration portable and remote power sources with a focus on providing solutions to the U.S. military and supplies complete power solutions and application engineering services to original equipment manufacturers customers. During the period, Protonex began trading its common shares on the AIM market of the London Stock Exchange under the stock symbol PTX.L . As a result, the Fund marks-to-market its investment in Protonex based on public pricing. At June 30, 2006, the Fund's investment in Protonex had a mark-to-market value of approximately \$3.8 million.

Jadoo Power Systems. The Fund has invested approximately \$1.2 million and owns 2,200,000 shares of Jadoo Power Systems ( Jadoo ) stock, which represents an approximate 5% ownership interest. Jadoo develops high energy density power products for the law enforcement, military and electronic news gathering applications. As of June 30, 2006, the Fund's investment in Jadoo had a valuation of approximately \$1.2 million.

Since the Fund's inception, the Company has recorded a cumulative \$0.8 million increase to our investment resulting primarily from unrealized gains of the Fund as a result of mark-to-market adjustments that have been made due to the increase in the value of our alternative energy investments, bringing our total investment in alternative energy investments, including cumulative mark-to-market adjustments, as of June 30, 2006, to approximately \$4.5 million.

**10. Income Taxes**

Actual income tax expense (benefit) differs from income tax expense (benefit) computed by applying the U.S. federal statutory corporate rate of 35 percent to pretax income (loss) as follows:

	Year Ended June 30,					
	2006		2005		2004	
Provision (benefit) at statutory tax rate	\$ (142,373)	-35.0%	\$ 6,694,724	35.0%	\$ 4,114,846	35.0%
State income tax provision (benefit), net of federal benefit	94,900	23.5%			(67,216)	-0.5%
Permanent differences benefit	(185,315)	-45.5%				0.0%
Other	32,970	8.0%	15,122	0.08%	8,723	
Income tax provision (benefit)	\$ (199,818)	-49.00%	\$ 6,709,846	35.08%	\$ 4,056,353	34.5%

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The provision (benefit) for income taxes for the periods indicated are comprised of the following:

	Year Ended June 30,		
	2006	2005	2004
<b>Current:</b>			
Federal	\$ (352,957)	\$ 9,983,768	\$ 4,693,367
State	146,000		(103,409)
<b>Total</b>	<b>\$ (206,957)</b>	<b>\$ 9,983,768</b>	<b>\$ 4,589,958</b>
<b>Deferred:</b>			
Federal	\$ 7,139	\$ (3,273,922)	\$ (533,605)
State			
<b>Total</b>	<b>\$ 7,139</b>	<b>\$ (3,273,922)</b>	<b>\$ (533,605)</b>
<b>Total:</b>			
Federal	\$ (345,818)	\$ 6,709,846	\$ 4,159,762
State	146,000		(103,409)
<b>Total</b>	<b>\$ (199,818)</b>	<b>\$ 6,709,846</b>	<b>\$ 4,056,353</b>

The Company's permanent benefits relate mainly to non-taxable interest on municipal bonds.

The net deferred tax asset (liability) is comprised of the following:

	Year Ended June 30,		
	2006	2005	2004
<b>Deferred tax asset:</b>			
Net operating loss carryover	\$ 2,805,770	\$	\$
Temporary basis differences in natural gas and oil properties and other	1,649,420	4,462,329	1,188,407
<b>Net deferred tax asset</b>	<b>\$ 4,455,190</b>	<b>\$ 4,462,329</b>	<b>\$ 1,188,407</b>

At June 30, 2006, the Company had a net operating loss for federal income tax purposes of \$2.8 million, which can be carried back two years and forward twenty years. Realization of net deferred tax assets associated with net operating loss carryovers is dependent upon generating sufficient taxable income prior to its expiration. The Company will fully utilize the net operating loss carryover by applying it to taxable income from the previous two years. The Company has not established a valuation allowance for deferred tax assets, as management currently believes that it is more likely than not that the net operating loss carryover will be fully utilized through taxable income from the past two years.

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**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**11. Long-Term Debt**

On April 27, 2006, the Company completed the arrangement of a new three-year \$20.0 million secured term loan agreement with The Royal Bank of Scotland ( RBS ). The term loan agreement is secured with the stock of Contango Sundance, Inc. ( Sundance ), our wholly-owned subsidiary. Sundance owns a 10% limited partnership interest in Freeport LNG, which owns the Freeport LNG facility. The Company has borrowed the first \$10.0 million under the term loan agreement and intends to borrow the remaining \$10.0 million at anytime prior to October 27, 2006. Borrowings under the term loan agreement bear interest, at the Company's option, at either (i) 30 day LIBOR, (ii) 60 day LIBOR, (iii) 90 day LIBOR or (iv) 6 month LIBOR, all plus 6.5%. Interest is due at the end of the LIBOR period chosen. The average interest rate charged as of June 30, 2006 was 11.69%. The principal is due April 27, 2009, but we may prepay after April 27, 2008 with no prepayment penalty. The term loan agreement required an arrangement fee of 2%, or \$400,000, which was paid upon closing.

The term loan agreement requires a minimum level of working capital, as defined in the term loan agreement. Additionally, the term loan agreement contains certain negative covenants that, among other things, restrict or limit our ability to incur indebtedness, sell certain assets, and pay dividends. Failure to maintain required working capital or comply with the term loan agreement's covenants could result in a default and acceleration of all indebtedness under the term loan agreement. As of June 30, 2006, the Company was in compliance with its financial covenants, ratios and other provisions of the term loan agreement.

The Company also maintains a \$0.1 million credit facility with Guaranty Bank, FSB that matures on June 29, 2008. As of June 30, 2006 and June 30, 2005, the Company had no long term debt outstanding under the Guaranty Bank facility.

Any future borrowings under the Guaranty Bank facility will bear interest, at the Company's option, at either (i) LIBOR plus two percent (2%) or (ii) the bank's base rate plus one-fourth percent (1/4%) per annum. Additionally, the Company pays a quarterly commitment fee of three-eighths percent (3/8%) per annum on the average availability.

The hydrocarbon borrowing base under the Guaranty Bank facility is subject to semi-annual redetermination based primarily on the value of our proved reserves. The credit facility requires the maintenance of certain ratios, including those related to working capital and debt service coverage, as defined in the credit agreements. Additionally, the credit agreements contain certain negative covenants that, among other things, restrict or limit our ability to incur indebtedness, sell assets, pay dividends and reacquire or otherwise acquire or redeem capital stock. Failure to maintain required financial ratios or comply with the credit facility's covenants can result in a default and acceleration of all indebtedness under the credit facility and the inability to borrow under the facility. As of June 30, 2006, the Company was in compliance with its financial covenants, ratios and other provisions of its credit facility.

**Index to Financial Statements****CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****12. Commitments and Contingencies**

Contango leases its office space and certain other equipment. As of June 30, 2006, minimum future lease payments are as follows:

Fiscal years Ending June 30,	
2007	\$ 51,219
2008	11,340
2009	10,395
2010 and Thereafter	
Total	\$ 72,954

The amount incurred under operating leases during the years ended June 30, 2006, 2005 and 2004 was \$139,744, \$110,404, and \$83,596, respectively.

**13. Stock Options**

In September 1999, the Company established the Contango Oil & Gas Company 1999 Stock Incentive Plan (the Option Plan). Under the Option Plan, the Company may issue up to 2,500,000 shares of common stock with an exercise price of each option equal to or greater than the market price of the Company's common stock on the date of grant, but in no event less than \$2.00 per share. The Company may grant key employees both incentive stock options intended to qualify under Section 422 of the Internal Revenue Code of 1986, as amended, and stock options that are not qualified as incentive stock options. Stock option grants to non-employees, such as directors and consultants, can only be stock options that are not qualified as incentive stock options. Options generally expire after five or ten years. The vesting schedule varies, but vesting generally occurs over a two-year period (1/3 immediately, 1/3 one year from the date of grant and 1/3 two years from the date of grant) or four-year period (1/4 one year from the date of grant and 1/4 two years, three years and four years from the date of grant). As of June 30, 2006, options under the Option Plan to acquire 955,000 shares of common stock at prices between \$3.00 and \$14.14 per share were outstanding.

In addition to grants made under the Option Plan, the Company has granted other options to purchase common stock outside the Option Plan. These options generally expire after five years. The vesting schedule varies, but vesting generally occurs either (i) immediately, (ii) over a two-year period (1/3 immediately, 1/3 one year from the date of grant and 1/3 two years from the date of grant), or (iii) under a vesting schedule that is tied to the payout and rate of return on specific projects for which the option was granted. As of June 30, 2006, other options to acquire 5,500 shares of common stock at prices between \$3.00 and \$3.33 per share were outstanding.



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## CONTANGO OIL &amp; GAS COMPANY AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

A summary of the status of the option plan and those options granted outside of the option plan as of June 30, 2006, 2005 and 2004, and changes during the fiscal years then ended, is presented in the table below:

	2006		Year Ended June 30, 2005		2004	
	Shares Under Options	Weighted Average Exercise Price	Shares Under Options	Weighted Average Exercise Price	Shares Under Options	Weighted Average Exercise Price
Outstanding, beginning of year	1,176,000	\$ 6.74	1,279,021	\$ 4.37	1,280,334	\$ 2.98
Granted	76,000	\$ 12.31	454,500	\$ 9.57	465,000	\$ 6.06
Exercised	(284,000)	\$ 4.10	(557,521)	\$ 3.65	(113,479)	\$ 2.79
Cancelled	(7,500)	\$ 5.17		\$	(352,834)	\$ 2.06
Outstanding, end of year	960,500	\$ 7.97	1,176,000	\$ 6.74	1,279,021	\$ 4.37
Aggregate intrinsic value	\$ 5,926,285		\$ 2,892,960		\$ 2,916,168	
Exercisable, end of year	561,292	\$ 6.82	501,167	\$ 5.01	766,187	\$ 4.05
Aggregate intrinsic value	\$ 4,108,657		\$ 2,099,888		\$ 1,992,086	
Available for grant, end of year	642,583		716,083		1,170,583	
Weighted average fair value of options granted during the year						
(1)	\$ 5.17		\$ 3.46		\$ 1.56	

- (1) The fair value of each option is estimated as of the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants during the years ended June 30, 2006, 2005 and 2004, respectively: (i) risk-free interest rate of 5.1 percent, 3.68 percent and 3.88 percent; (ii) expected lives of five years for the Option Plan and other options; (iii) expected volatility of 40 percent, 40 percent and 26 percent; and (iv) expected dividend yield of zero percent.

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## CONTANGO OIL &amp; GAS COMPANY AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The following table summarizes information about options that were outstanding at June 30, 2006:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Number of Shares Under Outstanding Options	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number of Shares Under Outstanding Options	Weighted Average Exercise Price
\$3.00 - \$3.99	67,500	3.7	\$ 3.12	37,500	\$ 3.05
\$4.00 - \$4.99	108,000	2.1	\$ 4.37	108,000	\$ 4.37
\$6.00 - \$6.99	284,000	2.9	\$ 6.78	278,667	\$ 6.78
\$7.00 - \$7.99	35,000	3.7	\$ 7.68	18,000	\$ 7.67
\$8.00 - \$8.99	6,000	3.8	\$ 8.35	4,000	\$ 8.35
\$9.00 - \$9.99	138,500	4.0	\$ 9.30	37,125	\$ 9.29
\$10.00 - \$10.99	250,000	4.0	\$ 10.23	62,500	\$ 10.23
\$11.00 - \$11.99	38,500	4.6	\$ 11.51	4,500	\$ 11.44
\$12.00 - \$12.99	19,500	4.6	\$ 12.67	6,500	\$ 12.67
\$14.00 - \$14.99	13,500	5.0	\$ 14.14	4,500	\$ 14.14
	960,500	3.5	\$ 7.97	561,292	\$ 6.82

Effective July 1, 2001, the Company changed its method of accounting for employee stock-based compensation to the fair value method prescribed in SFAS 123. Effective July 1, 2005, the Company adopted SFAS 123(R). Prior to the adoption of SFAS 123(R), we presented all tax benefits resulting from the exercise of stock options as operating cash flows in the Consolidated Statement of Cash Flows. SFAS 123(R) requires that cash flows from the exercise of stock options resulting from tax benefits in excess of recognized cumulative compensation cost (excess tax benefits) be classified as financing cash flows. For the year ended June 30, 2006, \$359,772 of such excess tax benefits was classified as financing cash flows. See Note 2 – Summary of Significant Accounting Policies.

All employee stock options grants are expensed over the stock options vesting period based on the fair value at the date the options are granted. The fair value of each option is estimated as of the date of grant using the Black-Scholes options-pricing model. During the fiscal year-ended June 30, 2006, 2005 and 2004, the Company recorded stock option expense of \$856,412, \$385,193 and \$339,005, respectively.

As of June 30, 2006, we have \$1,387,737 of total unrecognized compensation cost related to non-vested awards granted under our various share-based plans, which we expect to recognize over an average period of three years.

The aggregate intrinsic values of the options exercised during fiscal years 2006, 2005 and 2004 are \$2.2 million, \$2.2 million and \$0.4 million, respectively.

**14. Warrants**

As of June 30, 2006, the Company had no outstanding warrants. The final remaining issued warrants were exercised during the fiscal year ended June 30, 2006. The Company reserved an equal number of shares of common stock for issuance upon the exercise of its outstanding warrants. A summary of the Company warrants as of June 30, 2006, 2005 and 2004, and changes during the fiscal years then ended, is presented in the table below:

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	2006		Year Ended June 30, 2005		2004	
	Number of Shares Under Outstanding Warrants	Weighted Average Exercise Price	Number of Shares Under Outstanding Warrants	Weighted Average Exercise Price	Number of Shares Under Outstanding Warrants	Weighted Average Exercise Price
Outstanding, beginning of year	125,000	\$ 3.06	687,500	\$ 2.39	1,640,185	\$ 2.16
Exercised	(125,000)	\$ 3.06	(562,500)	\$ 2.00	(890,185)	\$ 2.00
Cancelled				\$	(62,500)	\$ 2.00
Outstanding, end of year			125,000	\$ 3.06	687,500	\$ 2.39
Exercisable, end of year			125,000	\$ 3.06	687,500	\$ 2.39

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**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

We received cash from options and warrants exercised during the years ended June 30, 2006, 2005 and 2004 of \$1.5 million, \$1.9 million and \$1.1 million, respectively. The impact of these cash receipts is included in financing activities in the accompanying Consolidated Statements of Cash Flows.

**15. Natural Gas and Oil Exploration Risk**

The Company's future financial condition and results of operations will depend upon prices received for its natural gas and oil production and the cost of finding, acquiring, developing and producing reserves. Substantially all of its production is sold under various terms and arrangements at prevailing market prices. Prices for natural gas and oil are subject to fluctuations in response to changes in supply, market uncertainty and a variety of other factors beyond the Company's control.

Other factors that have a direct bearing on the Company's financial condition are uncertainties inherent in estimating natural gas and oil reserves and future hydrocarbon production and cash flows, particularly with respect to wells that have not been fully tested and with wells having limited production histories; the timing and costs of our future drilling; development and abandonment activities; access to additional capital; changes in the price of natural gas and oil; availability and cost of services and equipment; and the presence of competitors with greater financial resources and capacity. The preparation of our financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect our reported results of operations, the amount of reported assets, liabilities and contingencies, and proved natural gas and oil reserves. We use the successful efforts method of accounting for our natural gas and oil activities.

**16. Sale of Properties Continuing Operations**

In December 2003, Contango and REX sold their producing Gulf of Mexico leases for approximately \$12.0 million. As a result of this sale, Contango recorded a gain of approximately \$6.2 million for the year ended June 30, 2004. Properties included in the sale were Eugene Island 110, Grand Isle 28 and High Island 25-L. Contango received approximately \$3.7 million in cash proceeds for its portion of the sale. REX received cash proceeds of approximately \$8.3 million for its portion of the sale. In connection with this sale, REX subsequently made distributions of \$3.0 million to its members, of which \$1.0 million was distributed to Contango.

**17. Gain on Sale of Marketable Securities**

As part of the formation of Freeport LNG, Cheniere Energy, Inc. (Cheniere) granted Contango warrants to purchase 300,000 shares of Cheniere common stock. In June and September 2003, Contango exercised the warrants, purchasing 300,000 shares of Cheniere common stock. All of the Company's marketable securities related to an investment in Cheniere common stock, were sold in fiscal year 2004 resulting in a gain of \$710,322 recognized under Gain on Sale of Marketable Securities.

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**CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**18. Related Party Transactions**

In the ordinary course of business, the Company contracted with Mobilize to install automation equipment that will allow COI to remotely monitor, control and record, in real time, daily production volumes from the Grand Isle 72 #1 well. For the year ended June 30, 2006, the Company paid \$25,000 to Mobilize for such services.

On March 31, 2006, COE executed in favor of the Company, a Promissory Note (the Note) in the aggregate principal amount of \$2,800,550. Under the terms of the Note, COE can borrow up to the stated amount to receive funding in connection with a certain Authority for Expenditure dated March 20, 2006 related to the Grand Isle 72 well, in which COE is a working interest owner. The Note is payable upon demand, and bears interest at a per annum rate of 10%. As of June 30, 2006, the outstanding principal balance under the Note was \$250,000 and the amount of accrued interest thereon was approximately \$6,000.

**19. Subsequent Events**

In July 2006, COE borrowed an additional \$500,000 under the existing Note, bringing the total outstanding principal balance under the Note to \$750,000.

In August 2006, the Company loaned \$125,000 to Trulite under a Promissory Note (the Trulite Note). The Note bears interest at a per annum rate of 11.25% until February 9, 2007, at which point the per annum rate will change to prime rate plus three percentage points until May 1, 2007, which is when the Note plus all accrued and unpaid interest is due.

In August 2006, the Company exercised its right pursuant to two warrants, to purchase 324,324 shares of Mobilize convertible preferred stock for \$0.6 million. The Company's total investment in Mobilize is \$1.2 million, for an approximate 33% ownership interest.

**Index to Financial Statements****CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES****SUPPLEMENTAL OIL AND GAS DISCLOSURES (Unaudited)**

The following disclosures provide unaudited information required by SFAS No. 69, Disclosures about Oil and Gas Producing Activities .

*Costs Incurred.* The following table presents information regarding our net costs incurred in the purchase of proved and unproved properties and in exploration and development activities for the periods indicated:

	Year Ended June 30,		
	2006	2005	2004
Property Acquisition Costs:			
Unproved	\$ 14,609,232	\$ 248,634	\$ 4,475,908
Proved			
Exploration costs	19,529,607	9,428,002	6,923,762
Developmental costs	590,395		983,933
Capitalized interest	149,365		
<b>Total costs</b>	<b>\$ 34,878,599</b>	<b>\$ 9,676,636</b>	<b>\$ 12,383,603</b>

*Natural Gas and Oil Reserves.* Proved reserves are estimated quantities of natural gas and oil that geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions. Proved developed reserves are proved reserves that reasonably can be expected to be recovered through existing wells with existing equipment and operating methods.

Proved natural gas and oil reserve quantities at June 30, 2006, 2005 and 2004, and the related discounted future net cash flows before income taxes are based on estimates prepared by W.D. Von Gonten & Co., petroleum engineering. Such estimates have been prepared in accordance with guidelines established by the Securities and Exchange Commission.

**Index to Financial Statements****CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES****SUPPLEMENTAL OIL AND GAS DISCLOSURES (Unaudited)**

The Company's net ownership interests in estimated quantities of proved natural gas and oil reserves and changes in net proved reserves as of June 30, 2006, 2005 and 2004, all of which are located in the continental United States, are summarized below:

	<b>Oil and Condensate (MBbls)</b>	<b>Natural Gas (MMcf)</b>
Proved Developed and Undeveloped Reserves as of:		
June 30, 2003	395	21,222
Sale of reserves	(82)	(830)
Discoveries	33	1,598
Recoveries and revisions	50	(2,028)
Production	(99)	(4,329)
June 30, 2004	297	15,633
Sale of reserves	(267)	(14,413)
Discoveries	69	166
Recoveries and revisions	29	1,649
Production	(51)	(2,124)
June 30, 2005	77	911
Sale of reserves	(203)	(1,076)
Discoveries	174	3,813
Recoveries and revisions		172
Production	(37)	(456)
June 30, 2006	11	3,364
Proved Developed Reserves as of:		
June 30, 2003	395	21,039
June 30, 2004	296	15,543
June 30, 2005	77	911
June 30, 2006	11	1,876

**Index to Financial Statements****CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES****SUPPLEMENTAL OIL AND GAS DISCLOSURES (Unaudited)**

*Standardized Measure.* The standardized measure of discounted future net cash flows relating to the Company's ownership interests in proved natural gas and oil reserves as of June 30, 2006, 2005 and 2004 are shown below:

	2006	As of June 30, 2005	2004
Future cash flows	\$ 20,342,459	\$ 10,639,610	\$ 108,709,979
Future operating expenses	(2,957,249)	(2,121,836)	(29,083,202)
Future development costs	(4,436,360)	(72,393)	(72,393)
Future income tax expenses	(1,389,931)	(2,255,844)	(20,387,797)
Future net cash flows	11,558,919	6,189,537	59,166,587
10% annual discount for estimated timing of cash flows	(3,824,813)	(938,937)	(14,187,835)
Standardized measure of discounted future net cash flows	\$ 7,734,106	\$ 5,250,600	\$ 44,978,752

Future cash flows are computed by applying fiscal year-end prices of natural gas and oil to year-end quantities of proved natural gas and oil reserves. Future operating expenses and development costs are computed primarily by the Company's petroleum engineers by estimating the expenditures to be incurred in developing and producing the Company's proved natural gas and oil reserves at the end of the year, based on year-end costs and assuming continuation of existing economic conditions.

Future income taxes are based on year-end statutory rates, adjusted for tax basis and applicable tax credits. A discount factor of 10 percent was used to reflect the timing of future net cash flows. The standardized measure of discounted future net cash flows is not intended to represent the replacement cost or fair value of the Company's natural gas and oil properties. An estimate of fair value would also take into account, among other things, the recovery of reserves not presently classified as proved, anticipated future changes in prices and costs, and a discount factor more representative of the time value of money and the risks inherent in reserve estimates of natural gas and oil producing operations.



**Index to Financial Statements****CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES****SUPPLEMENTAL OIL AND GAS DISCLOSURES (Unaudited)**

*Change in Standardized Measure.* Changes in the standardized measure of future net cash flows relating to proved natural gas and oil reserves are summarized below:

	Year Ended June 30,		
	2006	2005	2004
Changes due to current year operation:			
Sales of natural gas and oil, net of natural gas and oil operating expenses	\$ (7,301,314)	\$ (15,031,481)	\$ (23,741,629)
Extensions and discoveries	17,872,465	4,027,189	7,198,196
Net change in prices and production costs	249,397	1,087,868	8,581,369
Change in future development costs	(5,660)		58,322
Revisions of quantity estimates	1,023,322	6,894,659	(5,763,987)
Sale of reserves	(11,517,747)	(54,312,903)	(4,156,368)
Accretion of discount	708,142	5,976,673	6,962,714
Change in the timing of production rates and other	742,058	(1,327,312)	1,000,982
Changes in income taxes	712,843	12,957,155	2,279,563
Net change	2,483,506	(39,728,152)	(7,580,838)
Beginning of year	5,250,600	44,978,752	52,559,590
End of year	\$ 7,734,106	\$ 5,250,600	\$ 44,978,752

**Index to Financial Statements****CONTANGO OIL & GAS COMPANY AND SUBSIDIARIES****SUPPLEMENTAL OIL AND GAS DISCLOSURES (Unaudited)**

*Quarterly Results of Operations.* The following table sets forth the results of operations by quarter for the years ended June 30, 2006 and 2005:

	Quarter Ended			
	Sept. 30,	Dec. 31,	Mar. 31,	June 30,
	(\$000, except per share amounts)			
<b>Fiscal Year 2006:</b>				
Revenues from continuing operations	\$ 148	\$ 44	\$ 123	\$ 605
Revenues from discontinued operations	\$ 1,043	\$ 1,779	\$ 1,555	\$ 497
(Loss) from continuing operations (1)	\$ (477)	\$ (808)	\$ (855)	\$ (5,586)
Discontinued operations, net of income taxes	\$ 688	\$ 589	\$ 1,755	\$ 4,487
Net income (loss) attributable to common stock	\$ 60	\$ (368)	\$ 749	\$ (1,249)
Net income (loss) per share (2):				
Basic:				
Continuing operations	\$ (0.04)	\$ (0.07)	\$ (0.07)	\$ (0.38)
Discontinued operations	\$ 0.05	\$ 0.04	\$ 0.12	\$ 0.30
Diluted:				
Continuing operations	\$ (0.04)	\$ (0.07)	\$ (0.07)	\$ (0.38)
Discontinued operations	\$ 0.05	\$ 0.04	\$ 0.12	\$ 0.30
<b>Fiscal Year 2005:</b>				
Revenues from continuing operations	\$ 168	\$ 206	\$ 257	\$ 458
Revenues from discontinued operations	\$ 6,504	\$ 7,079	\$ 774	\$ 821
(Loss) from continuing operations (1)	\$ (786)	\$ (1,321)	\$ (1,416)	\$ (1,624)
Discontinued operations, net of income taxes	\$ 2,269	\$ 14,576	\$ 344	\$ 376
Net income (loss) attributable to common stock	\$ 1,378	\$ 13,150	\$ (1,177)	\$ (1,353)
Net income (loss) per share (2):				
Basic:				
Continuing operations	\$ (0.07)	\$ (0.11)	\$ (0.12)	\$ (0.13)
Discontinued operations	\$ 0.18	\$ 1.12	\$ 0.03	\$ 0.03
Diluted:				
Continuing operations	\$ (0.07)	\$ (0.11)	\$ (0.12)	\$ (0.13)
Discontinued operations	\$ 0.18	\$ 1.12	\$ 0.03	\$ 0.03

- (1) Represents natural gas and oil sales, less operating expenses, exploration expenses, depreciation, depletion and amortization, impairment of natural gas and oil properties, and general and administrative expense and other income after benefit (expense) for income taxes.
- (2) The sum of the individual quarterly earnings (loss) per share may not agree with year-to-date earnings (loss) per share as each quarterly computation is based on the income or loss for that quarter and the weighted average number of common shares outstanding during that quarter.

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**SIGNATURES**

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant has duly caused this Amendment No. 1 to be signed on its behalf by the undersigned, thereunto duly authorized.

**CONTANGO OIL & GAS COMPANY**

/s/ KENNETH R. PEAK

Kenneth R. Peak

Chairman, Chief Executive Officer and Chief Financial Officer  
(principal executive officer and principal financial officer)

/s/ LESIA BAUTINA

Lesia Bautina

Senior Vice President and Controller  
(principal accounting officer)

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**EXHIBIT INDEX**

<b>EXHIBIT NO.</b>	<b>DESCRIPTION</b>
23.2	Consent of Independent Registered Public Accounting Firm
31.1	Certification required by Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934
32.1	Certification pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.