

Form 10KSB for NEW CENTURY ENERGY CORP.

12-Apr-2007

Annual Report

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

This report contains forward looking statements within the meaning of Section 27a of the Securities Act of 1933 and Section 21e of the Securities Exchange Act of 1934. These forward looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results or anticipated results, including those set forth under "Risk Factors" in this Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in this report. The following discussion and analysis should be read in conjunction with "Selected Financial Data" and the Company's financial statements and notes thereto included elsewhere in this report. .

PLAN OF OPERATIONS OVERVIEW

During 2006, our operations grew externally through two successful acquisitions of mineral interests in proved producing and undeveloped oil and gas leases in the Mustang Creek Field area ("Mustang Creek"), located in McMullen County, Texas. We formed a new wholly owned subsidiary, Gulf Coast Oil Corporation ("Gulf Coast" or "GCOC") for financing these acquisitions. The formation of this subsidiary has contributed to the significant increase in our total assets of approximately \$66 million on the consolidated balance sheet of New Century Energy, as of December 31, 2006, of which \$29 million related to our new subsidiary Gulf Coast. Our total oil and gas proved reserves as of January 1, 2007, are estimated to total 2,055,000 equivalent barrels. Proved reserves for oil is estimated at 858,000 barrels, of which 719,000 barrels are expected from Gulf Coast leases. The 1,197,000 equivalent barrels of proved gas reserves are expected to be contributed by the Lindholm Hanson Gas Units and Wells ("L-H Gas Unit") acquired by New Century Energy in three acquisitions during 2005 and 2006 and our proved producing and proved undeveloped reserves associated with our Hamill & Hamill lease in the South Sargent Field in Matagorda County, Texas.

-39-

We achieve production and proved reserve growth primarily through producing property acquisitions, followed by low-risk development drilling generally funded by cashflow from production and outside financing. An unstable world market for gas and oil coupled with a mild winter in the fourth quarter of 2006 caused the prices of both gas and oil to drop significantly for the year ended December 31, 2006, as compared to the steady rise in gas and oil prices over the two prior years. The fluctuating market prices have not been reflected in the cost of operating the field. We continue to be challenged with rising cost trends that have put pressure not only on our operating costs, but also on our capital costs.

Like all oil and gas exploration and production companies, we face the challenge of natural production decline. An oil and gas exploration and production company depletes part of its asset base with each unit of oil and gas it produces. Despite this natural decline, we have been able to grow our production through acquisitions and development of existing fields, resulting in the addition of more reserves than we produced. Future growth will depend on our ability to continue this trend of adding reserves in excess of production at a reasonable cost.

During 2006, we secured three additional debt instruments to finance acquisition growth and development of existing fields. A \$40 million April 2006 note and a \$5 million June 2006 note were issued by Gulf Coast Oil Corporation, to finance the acquisitions in the Mustang Creek Area. In late December 2006, New Century signed a \$16.2 million note to refinance a portion of the Gulf Coast high interest debt and to make funds available for development in existing fields. In addition, amendments were signed to extend the maturity date of the \$9.5 million 2005 Secured Term Note, which is now due July 2, 2007; and to reduce the monthly principal payment due on the 2005 \$15 million Amended Convertible Note.

Our goal for 2007 is to increase reserves significantly. To achieve future production and reserve growth, we will continue to pursue acquisitions that meet our criteria and to complete development projects in our inventory of potential drilling locations. Our 2007 development drilling budget is approximately \$8,000,000. While an acquisition budget has not been formalized, we plan to actively review additional acquisition opportunities during 2007. We cannot ensure that we will be able to find properties that meet our acquisition criteria, that we can purchase such properties on acceptable terms, or secure the necessary funding to close additional acquisitions.

-40-

OPERATED PROPERTIES:

As of December 31, 2006, we estimated that our daily deliverability was approximately 2,300 Mcf of gas per day, and 620 Bpd of crude oil per day on Company operated properties. In the fourth quarter of 2006, we commenced our drilling program in McMullen County and as of March 30, 2007, we had drilled six prospects and set production casing in four (4) new wells. This drilling program will continue through the second quarter of 2007, and into the third quarter of 2007, as we continue to drill our prospects in McMullen County. Additional prospective acreage has been identified for oil and gas leasing in the Mustang Creek field area and new wells will be drilled on this acreage in 2007 and beyond. Our gas production declined in the South Sargent Field due to natural depletion of reservoirs over time. We have identified 5 new locations to be drilled in this field and its surrounding area in 2007 and beyond. As producing wells deplete in current producing sands, we expect to continue our recompletion program on our owned and operated wells.

In December 2006, we acquired an inactive wellbore and complete production facilities from Unit Petroleum Corporation and also purchased new oil and gas leases in Goliad County, Texas. We intend to recomplete the Lewis A-2 well in the second quarter of 2007, to exploit probable undeveloped gas reserves associated with this prospect.

During 2006, we continued interpretation of our 3-D seismic data base in Matagorda County, Texas. We received results of our first reprocessed seismic data in the first quarter of 2005 and completed the first phase of our structural and stratigraphic interpretation in the fourth quarter of 2005. We believe that the reprocessed 3-D seismic data allows us to better locate and optimize the structural placement of our new drilling locations.

While it is extremely difficult to accurately forecast future production, we believe that our recompletion and drilling programs in Matagorda and McMullen Counties will provide long-term production growth potential and will be an important source of our reserve growth for the foreseeable future, of which there can be no assurance.

During 2006 we acquired additional licenses to 2D and 3D seismic data in McMullen and Matagorda Counties. We also purchased two new 3D computer workstations and software packages to evaluate and interpret these 2D and 3D seismic data sets. We also hired two (2) fulltime exploration professionals to guide these interpretation projects.

NON-OPERATED PROPERTIES:

On June 30, 2005, we closed the acquisition of the various non-operated working, term royalty and overriding royalty interests in the Wishbone Field in McMullen County, Texas, with an effective date for ownership of April 1, 2005. On September 19, 2005, we closed the acquisition of additional various non-operated working interests in the Wishbone Field in McMullen County, Texas, with an effective date for ownership of July 1, 2005. On January 3, 2006, we closed the acquisition of an additional working interest in the Wishbone Field in McMullen County, Texas with an effective date for ownership of October 1, 2005. The purchase of the June 2005, September 2005 and January 2006 interests are described in greater detail above under "Description of Business."

-41-

As of December 31, 2006, we estimate that daily gas deliverability from Wishbone Field was approximately 11 MMCF of gas per day to the 8/8ths interest, with net production to the Company's working interest (13.45%) of approximately 1.4 MMCF of gas per day.

As of January 1, 2007, our third party engineers have attributed over 6.184 billion cubic feet of total proved gas reserves in the Wishbone Field to our net interest, with approximately \$32 million of undiscounted future net income attributed to our interests in the Wishbone Field. The acquisition of the Wishbone interest helped to increase our proved gas reserves significantly.

The Lindholm Hanson Gas Unit Well #1 was recompleted in December 2006 by plugging off the old perforations in the Wilcox House 3 Sand, and recompleting in the Wilcox House 2 sand with perforations at 12,310 to 12,324 feet. The new completion has not been acidized or frac treated, and is currently producing at a rate of 2,980 MCF/GPD with a flowing tubing pressure of 2,500 psi.

We currently have development plans in the Wishbone Field to drill additional new well locations to exploit proven, probable and possible gas reserves in 2007 or 2008 as the price of gas and cost of drilling allow.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses, contingent assets and liabilities and the related disclosures in the accompanying financial statements. Changes in these estimates and assumptions could materially affect our consolidated financial position, results of operations or cash flows. Management considers an accounting estimate to be critical if: (a) it requires assumptions to be made that were uncertain at the time the estimate was made and (b) changes in the estimate or different estimates that could have been selected could have a material impact on our consolidated results of operations or financial condition. All other significant accounting policies that we employ are presented in the notes to the consolidated financial statements. The following discussion presents information about the nature of our most critical accounting estimates, our assumptions or approach used and the effects of hypothetical changes in the material assumptions used to develop each estimate.

Oil and Gas Properties. -

We follow the successful efforts method of accounting for our investment in oil and natural gas properties. Under the successful efforts method, the costs of successful exploratory wells and leases containing productive reserves are capitalized. Costs incurred to drill and equip developmental wells, including unsuccessful development wells, are capitalized. Other costs such as geological and geophysical costs and the drilling costs of unsuccessful exploratory wells are expensed.

-42-

All capitalized costs are accumulated and recorded separately for each field and allocated to leasehold costs and well costs. Leasehold costs are depleted on a units-of-production basis based on the estimated remaining equivalent proved oil and gas reserves of each field. Well costs are depleted on a units-of-production basis based on the estimated remaining equivalent proved developed oil and gas reserves of each field.

Proved Reserve Estimates. -

Our estimate of proved reserves is based on the quantities of oil and gas which geological and engineering data demonstrate, with reasonable certainty, to be recoverable in future years from known reservoirs under existing economic and operating conditions. The accuracy of any reserve estimate is a function of the quality of available data, engineering and geological interpretation, and judgment. For example, we must estimate the amount and timing of future operating costs, severance taxes, development costs, and work-over costs, all of which may in fact vary considerably from actual results. In addition, as prices and cost levels change from year to year, the economics of producing the reserves may change and therefore the estimate of proved reserves also may change. Any significant variance in these assumptions could materially affect the estimated quantity and value of our reserves. Despite the inherent imprecision in these engineering estimates, our reserves are used throughout our financial statements. When converting proved gas reserves to barrel of oil equivalent, we use a conversion factor of 6,000:1, or 6,000 cubic feet of gas equaling 1 barrel of oil.

Long-Lived Assets -

We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of any such asset may not be recoverable. We record impairment losses on long-lived assets, including oil and gas properties, used in operations when the estimated cash flows to be generated by those assets are less than the carrying amount of those items. Our cash flow estimates are based upon, among other things, historical results adjusted to reflect our best estimate of future market rates, utilization levels, operating performance, and with respect to our oil and gas properties, future oil and natural gas sales prices, an estimate of the ultimate amount of recoverable oil and natural gas reserves that will be produced from a field, the timing of this future production, future costs to produce the oil and natural gas and other factors. Our estimate of fair value represents our best estimate based on industry trends and reference to market transactions and is subject to variability. The oil and gas industry is cyclical and our estimates of the period over which future cash flows will be generated, as well as the predictability of these cash flows, can have significant impact on the carrying value of these assets and, in periods of prolonged down cycles, may result in impairment charges.

Asset Retirement Obligations -

We have certain obligations to remove tangible equipment and restore land at the end of oil and gas production operations. Our removal and restoration obligations are primarily associated with plugging and abandoning wells. We adopted Statement of Financial Accounting Standards ("SFAS") No. 143, "Accounting for Asset Retirement Obligations" effective January 1, 2003, as discussed in Note 2 to our Consolidated Financial Statements. SFAS No. 143 significantly changed the method of accruing for costs an entity is legally obligated to incur related to the retirement of fixed assets ("asset retirement obligations" or "ARO"). Primarily, SFAS No. 143 requires us to estimate asset retirement costs for all of our assets, adjust those costs for inflation to the forecast abandonment date, discount that amount using a credit-adjusted-risk-free rate back to the date we acquired the asset or obligation to retire the asset and record an ARO liability in that amount with a corresponding addition to our asset value. When new obligations are incurred, i.e. new well drilled or acquired, we add a layer to the ARO liability. We then accrete the liability layers quarterly using the applicable period-end effective credit-adjusted-risk-free rates for each layer. Should either the estimated life or the estimated abandonment costs of a property change upon our quarterly

review, a new calculation is performed using the same methodology of taking the abandonment cost and inflating it forward to its abandonment date and then discounting it back to the present using our credit-adjusted-risk-free rate. The carrying value of the asset retirement obligation is adjusted to the newly calculated value, with a corresponding offsetting adjustment to the asset retirement cost; therefore, abandonment costs will almost always approximate the estimate. When well obligations are relieved by sale of the property or plugging and abandoning the well, the related liability and asset costs are removed from our balance sheet.

Derivatives -

We follow the provisions of SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133") along with related interpretations EITF No. 00-19 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" ("EITF-19") and EITF No. 05-2 "The Meaning of 'Conventional Convertible Debt Instrument' in Issue No. 00-19" ("EITF 05-2"). SFAS No. 133 requires every derivative instrument (including certain derivative instruments embedded in other contracts) to be recorded in the Balance Sheet as either an asset or liability measured at its fair value, with changes in the derivative's fair value recognized currently in earnings unless specific hedge accounting criteria are met.

We value these derivative securities under the fair value method at the end of each reporting period (quarter and annual), and their value is marked to market at the end of each reporting period with the gain or loss recognition recorded against earnings. We continue to revalue these instruments each quarter and year to reflect their current value in light of the current market price of our common stock. As a result, our consolidated financial statements may fluctuate from quarter to quarter and year to year based on the change in fair value of the derivatives and therefore our consolidated financial position and results of operations may vary significantly from quarter to quarter and year to year, based on factors other than the Company's revenues and expenses.

-44-

We utilize the Black-Scholes option-pricing model to determine the fair value of our freestanding derivative instruments. Key assumptions of the Black-Scholes option-pricing model include applicable volatility rates, risk-free interest rates and the instruments expected remaining life. We also determined a fair value for our various embedded derivatives within our \$15 million Convertible Note by using a layered, discounted, probability-weighted cash flow model. The assumptions used in both modeling techniques required significant management judgment and estimates of future fluctuation in stock price as well as changes in future interest rates. The reader should reference Note 6 in the "Notes to Consolidated Financial Statements" for further details in regards to our derivative liabilities.

Extinguishment of Debt -

We follow the provisions of SFAS No. 140 "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" ("SFAS No. 140") along with related interpretations from Emerging Issues Task Force No. 96-19 ("EITF No. 96-19"). The Task Force reached a consensus that an exchange of debt instruments with substantially different terms is a debt extinguishment and should be accounted for in accordance with paragraph 16 of SFAS No. 140. The Task Force also observed that a debtor could achieve the same economic effect by making a substantial modification of terms of an existing debt instrument. Accordingly, the Task Force reached a consensus that a substantial modification of terms should be accounted for like, and reported in the same manner as, an extinguishment of debt.

From the debtor's perspective, an exchange of debt instruments between or a modification of a debt instrument by a debtor and a creditor in a non-troubled debt situation is deemed to have been accomplished with debt instruments that are substantially different in the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument.

In evaluating the refinancing that occurred in December 2006 when New Century Energy Corp exchanged proceeds costing 10.25% interest for that costing 17.5% interest in terms of present value, it was deemed that SFAS 140 did not apply since the 17.5% note was liquidated. The present value of the other note instruments modified in the transaction did not change by more than the minimum of ten percent.

With the Third Amendment to the 2005 Amended Convertible Note and the December Option, the Company has determined that a greater than 10% difference in the net present value of the remaining cash flows of both the original Convertible Note and the New Convertible Note has occurred. Therefore, the original Convertible Note, along with the related unamortized discounts and deferred loan costs, has been extinguished and a New Convertible Note has been recorded at its fair value on December 30, 2005. The extinguishment required the Company to record an extinguishment debt expense of \$8,309,759.

-45-

Income Taxes -

The amount of income taxes recorded by us requires the interpretation of complex rules and regulations of various taxing jurisdictions throughout the world. We have recognized deferred tax assets and liabilities for all significant temporary differences, operating losses and tax credit carryforwards. We routinely assess the realizability of our deferred tax assets and reduce such assets by a valuation allowance if it is more likely than not that some portion or all of the deferred tax assets will not be realized. We routinely assess potential tax contingencies and, if required, establish accruals for such contingencies. The accruals for deferred tax assets and liabilities are subject to a significant amount of judgment by us and we review and adjust routinely our estimates based on changes in facts and circumstances. Although we believe our tax accruals are adequate, material changes in these accruals may occur in the future, based on the progress of ongoing tax audits, changes in legislation and resolution of pending tax matters.

Stock-Based Compensation.-

On December 16, 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment", which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123(R) supersedes Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees", and amends SFAS No. 95, "Statement of Cash Flows." Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123; however, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, be recognized in the income statement based on their fair values. Pro forma disclosure will no longer be an alternative.

SFAS No. 123(R) permits public companies to adopt its requirements using one of two methods:

1. A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS No. 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123(R) that remain unvested on the effective date.
2. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

We have elected the modified prospective transition method.

In March 2005, the SEC issued Staff Accounting Bulletin ("SAB") No. 107 which expressed the views of the SEC regarding the interaction between SFAS No. 123(R) and certain SEC rules and regulations. SAB No. 107 provides guidance related to the valuation of share-based payment arrangements for public companies, including assumptions such as expected volatility and expected term. In April 2005, the SEC approved a rule that delayed the effective date of SFAS No. 123(R) for public companies. As a result, SFAS No. 123(R) will be effective for us on January 1, 2006.

Accounting pronouncements

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities", which permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The statement amends SFAS No. 115, "Accounting for Certain Investments in Debt and Equity".

In December 2006, the FASB issued the FASB Staff Position (FSP) No. EITF 00-19-2, ("FSP EITF 00-19-2"), Accounting for Registration Payment Arrangements. This FSP addresses an issuer's accounting for registration payment arrangements. This FSP specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, Accounting for Contingencies. The guidance in this FSP amends FASB Statements No. 133, Accounting for Derivative Instruments and Hedging Activities, and No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, and FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, to include scope exceptions for registration payment arrangements. This FSP further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other applicable generally accepted accounting principles (GAAP) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. This FSP shall be effective immediately for registration payment arrangements and the financial instruments subject to those arrangements that are entered into or modified subsequent to the date of issuance of this FSP, or for financial statements issued for fiscal years beginning after December 15, 2006, and interim periods within those fiscal years.

The Company intends to adopt FSP EITF 00-19-2 beginning in 2007. The adoption of this FSP upon the Company's financial statements has not been determined.

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement No. 158 "Employers' Accounting For Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements Nos. 87, 88, 106 and 132(R)" ("SFAS 158"), which requires companies to recognize the funded status of a defined benefit postretirement plan as an asset or liability in its balance sheet. SFAS 158 is effective for fiscal years ending after December 15, 2006. We have no defined benefit plans; therefore we do not expect the adoption of SFAS 158 to have an impact on our consolidated financial position, results of operations or cash flows.

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