

CANO PETROLEUM, INC

Form POS AM

January 23, 2007

AS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ON JANUARY 23, 2007

REGISTRATION NO. 333 129979

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

POST-EFFECTIVE AMENDMENT NO. 1

ON

FORM S-1

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

CANO PETROLEUM, INC.

(Exact Name of Registrant as Specified in its Charter)

Delaware

(State or jurisdiction of
incorporation or organization)

1311

(Primary Standard Industrial
Classification Code Number)

77-0635673

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

801 Cherry St., Suite 3200

Fort Worth, TX 76102

(817) 698-0900

(Address and telephone number of principal executive offices)

S. Jeffrey Johnson, Chief Executive Officer

801 Cherry St., Suite 3200

Fort Worth, TX 76102

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(Name, address and telephone number of agent for service)

Copies to:

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APPROXIMATE DATE OF PROPOSED SALE TO PUBLIC: **As soon as practicable after this registration statement becomes effective.**

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933 check the following box: X

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. O

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. O

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. O

The registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until this Registration Statement shall become effective on such date as the Securities and Exchange Commission, acting pursuant to said Section 8(a), may determine.

PRELIMINARY PROSPECTUS, SUBJECT TO COMPLETION, DATED JANUARY 23, 2007

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

**3,633,264 Shares of
Common Stock**

This prospectus relates to the public offering of an aggregate of 3,633,264 currently outstanding shares of common stock, par value \$.0001 per share, which may be sold from time to time by the selling stockholders of Cano Petroleum, Inc. named in this prospectus. The shares of common stock are being registered to permit the selling stockholders to sell the shares from time to time in the public market. The stockholders may sell the shares through ordinary brokerage transactions, directly to market makers of our shares or through any other means described in the section entitled *Plan of Distribution* beginning on page 86. We cannot assure you that the selling stockholders will sell all or any portion of the shares offered in this prospectus.

THIS FILING DOES NOT INVOLVE THE REGISTRATION OF ANY NEW SHARES OF COMMON STOCK. RATHER, THIS FILING UPDATES THE REGISTRATION OF THE COMMON STOCK ORIGINALLY REGISTERED ON FORM SB-2 FILED ON NOVEMBER 29, 2005. IN ACCORDANCE WITH THE PURCHASE AGREEMENTS ENTERED WITH THE INVESTORS, WE ARE OBLIGATED TO MAINTAIN AN EFFECTIVE REGISTRATION STATEMENT FOR A SPECIFIC PERIOD OF TIME.

We have paid the expenses of preparing this prospectus and the related registration expenses.

Our common stock is traded on the American Stock Exchange (AMEX) under the symbol CFW. The closing sales price for our common stock on January 19, 2007 was \$5.25 per share. Our principal office is located at 801 Cherry St., Suite 3200, Fort Worth, Texas 76102, and our telephone number is 817.698.0900.

**The common stock offered hereby involves a high degree of risk
See *Risk Factors* beginning on page 6.**

We may amend or supplement this prospectus from time to time by filing amendments or supplements as required. You should read the entire prospectus and any amendments or supplements carefully before you make your investment decision.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus is _____, 2007.

CANO PETROLEUM, INC.

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PROSPECTUS SUMMARY

The following summary highlights selected information contained in this prospectus. This summary does not contain all the information you should consider before investing in the securities. Before making an investment decision, you should read the entire prospectus carefully, including the Risk Factors section, the financial statements and the notes to the financial statements. As used throughout this prospectus, the terms Cano, we, us, and our refer to Cano Petroleum, Inc. We have provided definitions for some of the oil and natural gas industry terms used in this prospectus in the Glossary of Oil and Natural Gas Terms on page 91 of this prospectus. Crude oil and natural gas equivalents are determined using the ratio of six Mcf of natural gas to one Bbl of crude oil, condensate or natural gas liquids.

Cano Petroleum, Inc.

Introduction

Cano Petroleum, Inc. is a growing independent oil and natural gas company. Our strategy is to acquire assets with a high ratio of non-proven or proved undeveloped reserves suitable for enhanced oil recovery (EOR) techniques, primarily on the onshore United States for a low cost. We intend to convert these non-proven and/or proved undeveloped reserves into proved producing reserves by applying water, gas or chemical flooding and other EOR techniques. During our first two years of operations, our primary focus has been to achieve growth through acquiring interests in existing, mature fields in Texas and Oklahoma. We believe the portfolio of oil and natural gas properties we have acquired to date provides suitable opportunities to apply EOR techniques. As of July 1, 2006, we had proved reserves of 45,385 MBOE, of which 9,350 MBOE were proved producing, 1,555 MBOE were proved non-producing, and 34,480 MBOE were proved undeveloped.

We were organized under the laws of the State of Delaware in May 2003 as Huron Ventures, Inc. On May 28, 2004, we merged with Davenport Field Unit, Inc., an Oklahoma corporation, and certain other entities (the Davenport Merger). In connection with the Davenport Merger, we changed our name to Cano Petroleum, Inc. Prior to the Davenport Merger, we were inactive with no significant operations.

Our Properties

Davenport Properties. In the Davenport Merger, we acquired assets in Lincoln County, Oklahoma (the Davenport Properties) for 5,165,000 shares of our common stock and \$1,650,000 cash. Proved reserves as of July 1, 2006 attributable to the Davenport Properties are 1,587 MBOE, of which 1,164 MBOE are proved non-producing and none of which are proved undeveloped. As a result of ongoing waterflood operations on the Davenport Properties, current production is approximately 65 BOEPD. During the fiscal year ending June 30, 2007 (Fiscal Year 2007), we anticipate bringing 13 existing non-producing wells to production via workover and converting 11 non-injection wells into injection. A surfactant polymer pilot is currently anticipated to be initiated in the first calendar quarter of 2008, contingent upon successful laboratory studies.

Rich Valley Properties. In July 2004, we acquired assets in Grant County, Oklahoma (the Rich Valley Properties), through our acquisition of Ladder Companies, Inc., a Delaware corporation, for approximately \$2.2 million. Proved reserves as of July 1, 2006 attributable to the Rich Valley Properties are 602 MBOE, all of which are proved producing. Current production is approximately 133 BOEPD. We are presently evaluating the Rich Valley Properties for sale.

Nowata Properties. In September 2004, we acquired more than 220 wells producing from the Bartlesville Sandstone (the Nowata Properties) for approximately \$2.6 million . Proved reserves as of July 1, 2006 attributable to the Nowata Properties are 1,305 MBOE, all of which are

proved producing. As a result of prior waterflood operations on the Nowata Properties, current net production is approximately 206 BOEPD. We have begun returning approximately 15 wells to production. Additionally, we anticipate a 2.5 acre Surfactant Polymer Pilot by June 2007 with preliminary results anticipated by January 2008.

Desdemona Properties. In March 2005, in connection with our acquisition of Square One Energy, Inc. for \$7.6 million, consisting of \$4 million in cash and 888,888 shares of our common stock valued at \$3.96 per share, we acquired a 100% working interest in 10,300 acres in mature oil fields in central Texas (the Desdemona Properties). Proved reserves as of July 1, 2006 attributable to the Desdemona Properties are 625 MBOE, of which 391 MBOE are proved non-producing and none of which are proved undeveloped. Current production is approximately 30 BOEPD. During Fiscal Year 2007, we anticipate having one drilling rig under contract at Desdemona to perform the drilling of an initial 7 wells in the Hogtown-Moore Unit Waterflood anticipated to commence during the quarter ending March 31, 2007. The field work required to start water flood injection, including numerous well re-works, facilities installation and drilling are expected to be completed by May 31, 2007. We expect initial response from the waterflood operations by October 31, 2007. If there is a successful waterflood response, it is anticipated that a surfactant polymer pilot will be initiated in the field. We have allocated additional funds from the Fiscal Year 2007 capital budget to drill 20 vertical tests penetrating the Marble Falls and/or Barnett Shale in the Desdemona Properties. We have drilled 8 Marble Falls and/or Barnett Shale wells in this field to date and have announced a new field discovery in the Barnett Shale.

Corsicana Properties. During 2005, we began acquiring oil and natural gas leases comprising the Corsicana Properties (the Corsicana Properties). Currently, we have a 100% working interest in 341 acres under lease and no current production from these properties. The Corsicana Properties were the subject of a proved surfactant-polymer chemical injection pilot in the 1980s and contain proved reserves as of July 1, 2006 of 848 MBOE, all of which are proved undeveloped. Our Fiscal Year 2007 capital budget contemplates re-implementation of a prior waterflood. 16 new wells are planned to be drilled by December 31, 2006 in this reservoir (which contained 7 MMBOE of original oil in place) to develop an effective sweep pattern and re-energize the formation. We have drilled 14 wells to date and expect facilities installation and well re-works to be complete by June 30, 2007 to start water injection. A surfactant polymer injection application is anticipated once the waterflood reimplementation is complete.

Panhandle Properties. On November 29, 2005, through our acquisition of W.O. Energy of Nevada, Inc. for an adjusted cash price of \$48.4 million and 1,791,320 shares of common stock with an aggregate value of approximately \$8.24 million, we acquired inventory, 10 workover rigs and related equipment, 480 producing wells, 40 water disposal wells and 380 idle wells on approximately 20,000 acres in Carson, Gray and Hutchinson Counties, Texas (the Panhandle Properties). Proved reserves as of July 1, 2006 attributable to the Panhandle Properties are 33,358 MBOE, of which 28,685 MBOE are proved undeveloped and none of which is proved non-producing. Current production is approximately 654 BOEPD. This asset in the Brown Dolomite formation contained over 382 MMBOE of original oil in place and is surrounded by successful waterflood analogs, with the Panhandle Properties having never been subject to any form of secondary recovery. Included in our Fiscal Year 2007 capital budget is an initial Phase I development at the 1,500 acre Cockrell Ranch Unit which will include expenditures of approximately \$9.8 million and which development has been initiated. Phase I development will be comprised of installation of injection facilities, drilling of 14 new wells and conversion of 8 existing producers to injection. The Phase I development will be executed with one contract drilling rig, and 5 workover rigs that are owned by our wholly-owned subsidiary W.O. Operating Company, Ltd. Phase II and Phase III development of the Cockrell Ranch Unit is anticipated to include the re-drilling of 27 additional wells and the conversion of 48 existing producers to injection. In total, the Cockrell Ranch Unit development is anticipated to have 72 injection wells and 64 producers. Phase I

injection is anticipated to commence by April 2007 with preliminary production response anticipated by October 2007. Full waterflood development over the remaining 11,000+ net acres of the Panhandle Properties is anticipated once the initial response data is available.

Pantwist Properties. Effective February 1, 2006, our wholly-owned subsidiary, Pantwist LLC, acquired additional properties, including 167 wells and 2 workover rigs and covering approximately 9,700 acres in the Panhandle field (the Pantwist Properties) for a cash purchase price of \$23.4 million. Proved reserves as of July 1, 2006 attributable to the Pantwist Properties are 7,060 MBOE, of which 4,947 MBOE are proved undeveloped and none of which are proved non-producing. Current production is approximately 356 BOEPD. We anticipate implementation of waterflood injection operations with respect to the Pantwist Properties in the 2008-2009 timeframe.

Planned Development Program

We are in the process of implementing a development program on our properties to further develop proved undeveloped reserves and to increase our reserve base. To date, we have conducted limited development operations on our properties. These operations have involved laboratory testing to evaluate EOR opportunities, design and initial construction of pilot area facilities, and some developmental drilling, including core evaluations, reservoir simulation studies and other development studies and evaluations.

For the fiscal year ended June 30, 2007 we have a capital budget of \$41 million. The largest portion of the capital budget, approximately 47%, or \$19.4 million, is allocated to waterflood development in the Panhandle Properties. Approximately 10%, or \$4.1 million, is allocated to waterflood development in the Desdemona Properties. Approximately 14%, or \$5.8 million, is allocated to surfactant polymer pilot programs at the Nowata and Corsicana Properties. Approximately \$9.6 million, or 24%, is targeted to drill a twenty-well Marble Falls/Barnett Shale program at the Desdemona Properties.

Waterflood operations and EOR techniques such as surfactant-polymer chemical injection involve significant capital investment and an extended period of time, generally a year or longer, from the initial phase of a program until increased production occurs. Generally, surfactant polymer injection is regarded as more risky compared to waterflood operations. Our ability to successfully convert proved undeveloped reserves to proved producing reserves will be contingent upon our ability to obtain future financing and/or raise additional capital, and further, is greatly contingent upon inherent uncertainties associated with the production of oil and natural gas as well as price volatility. See *Risk Factors*.

Industry Conditions

We believe significant acquisition opportunities will continue to exist primarily because the major energy companies and large independents continue to focus their attention and resources toward the discovery and development of large fields. During the past several years, the major companies have been divesting themselves of their mature oilfields, a trend management expects will continue. Also, the recent economics of the oil and natural gas market have improved as prices have risen substantially. These conditions provide ample opportunities for smaller independent companies to acquire and exploit mature U.S. fields. We expect that there will be increased competition for such properties in the future.

Our Strategy

- **Acquire Strategic Assets.** We seek to acquire low-cost assets with a high ratio of non-proven or proved undeveloped reserves suitable for waterflood and EOR techniques, primarily in the onshore United States. We believe we have acquired an attractive portfolio

of assets to implement our business plan. We will continue to selectively target potential acquisition candidates in a disciplined manner, which involves being financially prudent and acquiring assets that meet our engineering and operational standards. We focus on U.S. operations. Accordingly, we are not subject to geopolitical uncertainties, dependence on foreign sources and other issues related to overseas operations.

- ***No Exploration Risk.*** Our portfolio is comprised of mature fields with proven reserves, existing infrastructure and abundant technical information. Accordingly, our production growth is not dependent on exploration drilling and the high degree of speculation in making new discoveries.
- ***Exploit and Develop Existing Properties.*** We intend to add proved reserves to, and increase production from, our existing properties through the application of advanced technologies, including water, gas or chemical flooding and other EOR techniques. We believe that our management team has a proven track record of exploiting underdeveloped properties to increase reserves and cash flow.
- ***Maintain a Low Cost Structure.*** We intend to maintain a low cost structure through maintaining efficient operations and operating control. We intend to be the working interest operator in a high proportion of our properties. This allows us to exercise more control over expenses, capital allocation, and the timing of development and exploitation activities in our fields. It also enables us to implement controls over our costs to ensure prudent expenditures. Further, we employ engineering and geological consultants to aid in evaluating the economic merits of drilling plans and potential acquisitions on a case-by-case basis rather than staffing at such level, enabling us to maintain low fixed costs.

Recent Financing

On September 6, 2006, we sold in a private placement, preferred stock, common stock and associated warrants for aggregate gross proceeds of approximately \$80.9 million. We used approximately \$68.75 million to repay our long-term debt. The remainder has been and will be used for working capital and general corporate purposes, including the funding of our fiscal 2007 capital budget.

Our principal executive offices are located at 801 Cherry St., Suite 3200, Fort Worth, Texas 76102. Our telephone number is (817) 698-0900. Our website is located at www.canopetro.com.

The Offering

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Common stock outstanding before the offering	32,308,894 shares (1).
Common stock offered by selling stockholders	3,633,264 shares (2).
Common stock to be outstanding after the offering	32,308,894 shares.
Use of proceeds	We will not receive any proceeds from sales made by the selling stockholders.
AMEX Symbol	CFW

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Forward-Looking Statements

This prospectus contains forward-looking statements that address, among other things, our strategy to develop our business, projected capital expenditures, liquidity, and our development of additional revenue sources. The forward-looking statements are based on our current expectations and are subject to risks, uncertainties and assumptions. We base these forward-looking statements on information currently available to us, and we assume no obligation to update them. Our actual results may differ materially from the results anticipated in these forward-looking statements, due to various factors.

Risk Factors

For a discussion of certain risks associated with an investment in our common stock, please see the section entitled *Risk Factors* beginning on page 6 of this prospectus.

(1) Does not include as of January 19, 2007 the (i) 1,646,062 shares of common stock issuable upon exercise of the warrants which are exercisable beginning on March 5, 2007, (ii) 8,679,906 shares of common stock issuable upon conversion of the 49,116 shares of our Series D Convertible Preferred Stock which are currently convertible or (iii) 894,185 shares of common stock issuable upon exercise of our currently outstanding stock options.

(2) Represents the 3,633,264 shares of common stock currently outstanding.

RISK FACTORS

Our business involves a high degree of risk. Potential investors should carefully consider the risks and uncertainties described below and the other information in this prospectus before deciding whether to invest in shares of our common stock. Each of the following risks may materially and adversely affect our business, results of operations and financial condition. These risks may cause the market price of our common stock to decline, which may cause you to lose all or a part of the money you paid to buy our common stock.

Risks Related to Our Industry

Oil and natural gas prices are volatile. A decline in prices could adversely affect our financial position, financial results, cash flows, access to capital and ability to grow.

Our revenues, operating results, profitability and future rate of growth depend primarily upon the prices we receive for the oil and natural gas we produce and sell. Prices also affect the amount of cash flow available for capital expenditures and our ability to borrow money or raise additional capital. Historically, the markets for oil and natural gas have been volatile and they are likely to continue to be volatile. Wide fluctuations in oil and natural gas prices may result from relatively minor changes in the supply of and demand for oil and natural gas, market and political uncertainty and other factors that are beyond our control, including:

- worldwide and domestic demands and supplies of oil and natural gas;
- weather conditions;
- the price and availability of alternative fuels;
- the availability of pipeline capacity;
- the price and level of foreign imports;
- domestic and foreign governmental regulations and taxes;
- the ability of the members of the Organization of Petroleum Exporting Countries to agree to and maintain oil price and production controls;
- political instability or armed conflict in oil-producing regions; and
- the overall economic environment.

These factors and the volatility of the energy markets make it extremely difficult to predict future oil and natural gas price movements with any certainty. Declines in oil and natural gas prices would not only reduce revenue, but could reduce the amount of oil and natural gas that we can produce economically and, as a result, could have a material adverse effect on our financial condition, results of operations and reserves.

Government regulation may adversely affect our business and results of operations.

Oil and natural gas operations are subject to various and numerous federal, state and local government regulations, which may be changed from time to time. Matters subject to regulation include discharge permits for drilling operations, drilling bonds, reports concerning operations, the spacing of wells, injection of substances, unitization and pooling of properties and taxation. From time to time, regulatory agencies have imposed price controls and limitations on production by restricting the rate of flow of oil and natural gas wells below actual production capacity in order to conserve supplies of oil and natural gas. There are federal, state and local laws and regulations primarily relating to protection of human health and the environment applicable to the development, production, handling, storage, transportation and disposal of oil and natural gas, by-products thereof and other substances and materials produced or used in connection with oil and natural gas

operations. The transportation and storage of refined products include the risk that refined products and other hydrocarbons may be suddenly or gradually released into the environment, potentially causing substantial expenditures for a response action, significant government penalties, liability to government agencies and private parties for natural resources damages, personal injury, or property damages and significant business interruption. We own or lease a number of properties that have been used to store or distribute refined and unrefined products for many years. Many of these properties have also been operated by third parties whose handling, disposal, or release of hydrocarbons and other wastes were not under our control. As a result, we may incur substantial expenditures and/or liabilities to third parties or governmental entities which could have a material adverse effect on us.

The oil and natural gas industry is capital intensive, and we may not be able to raise the necessary capital in the future.

The oil and natural gas industry is capital intensive. We make substantial capital expenditures for the acquisition, exploration for and development of oil and natural gas reserves.

Historically, we have financed capital expenditures primarily with cash generated by operations, proceeds from bank borrowings and sales of our equity securities. In addition, we may consider selling additional non-core assets to raise additional operating capital.

Our cash flow from operations and access to capital are subject to a number of variables, including:

- our proved reserves;
- the level of oil and natural gas we are able to produce from existing wells;
- the prices at which oil and natural gas are sold; and
- our ability to acquire, locate and produce new reserves.

Any one of these variables can materially affect our ability to borrow under our revolving credit facility.

If our revenues or the borrowing base under our revolving credit facility decreases as a result of lower oil and natural gas prices, operating difficulties, declines in reserves or for any other reason, we may have limited ability to obtain the capital necessary to undertake or complete future drilling projects. We may, from time to time, seek additional financing, either in the form of increased bank borrowings, sales of debt or equity securities or other forms of financing, and there can be no assurance as to the availability of any additional financing upon terms acceptable to us.

Risks Related to Our Business

Our limited history makes an evaluation of us and our future difficult and profits are not assured.

Prior to the Davenport Merger in May 2004, we were inactive with no significant operations. In connection with the Davenport Merger, we decided to focus our business on the acquisition of attractive crude oil and natural gas prospects, and the exploration, development and production of oil and natural gas on these prospects. Since that time, we have acquired rights in oil and natural gas properties and undertaken certain exploitation and other activities. However, we do not have a long operating history in our current business and have not initiated any new waterflooding or EOR technologies on our own on any of our properties. In view of our limited history in the oil and natural gas business, you may have difficulty in evaluating us and our business and prospects. You must consider our business and prospects in light of the risks, expenses and difficulties frequently

encountered by companies in their early stage of development. For our business plan to succeed, we must successfully undertake most of the following activities:

- Find and acquire rights in attractive oil and natural gas properties;
- Develop our oil and natural gas properties, including the successful application of EOR technologies and procedures, to the point at which oil and natural gas are being produced in commercially viable quantities;
- Contract with third party service providers regarding services necessary to develop our oil and natural gas wells;
- Contract with transporters and purchasers of our commercial production of oil and natural gas;
- Maintain access to funds to pursue our capital-intensive business plan;
- Comply with all applicable laws and regulations;
- Implement and successfully execute our business strategy;
- Respond to competitive developments and market changes; and
- Attract, retain and motivate qualified personnel.

There can be no assurance that we will be successful in undertaking such activities. Our failure to undertake successfully most of the activities described above could materially and adversely affect our business, prospects, financial condition and results of operations. In addition, there can be no assurance that our exploitation and production activities will produce oil and natural gas in commercially viable quantities. There can be no assurance that sales of our oil and natural gas production will ever generate sufficient revenues or that we will be able to sustain profitability in any future period.

If we cannot obtain sufficient additional capital when needed, we will not be able to continue with our business strategy. In addition, significant infusions of additional capital may result in dilution to your ownership and voting rights in our securities.

Our business strategy is to acquire interests in mature oil fields with established reserves that have declined to marginal production levels, but possess significant remaining upside exploitation potential, and implement various secondary and tertiary enhanced oil recovery operations. We are focused on acquiring undervalued properties that feature enhanced recovery opportunities. As we continue to find acquisition candidates, we may require additional capital to finance the acquisitions as well as to conduct our EOR operations. We may not be able to obtain additional financing in sufficient amounts or on acceptable terms when needed, which could adversely affect our operating results and prospects. If we cannot raise the additional capital required to implement our business strategy, we may be required to curtail operations or develop a different strategy, which could adversely affect our financial condition and results of operations. Further, any debt financing must be repaid regardless of whether or not we generate profits or cash flows from our business activities. Equity financing may result in dilution to existing stockholders and may involve securities that have rights, preferences, or privileges that are senior to our common stock.

The actual quantities and present value of our proved reserves may be lower than we have estimated.

This prospectus contains estimates of our proved reserves. The process of estimating oil and natural gas reserves is complex. The process involves significant decisions and assumptions in the evaluation of available geological, geophysical, engineering and economic data for each reservoir. Therefore, these estimates are inherently imprecise. Actual future production, oil and natural gas

prices, revenues, taxes, development expenditures, operating expenses and quantities of recoverable oil and natural gas reserves most likely will vary from these estimates and vary over time. Such variations may be significant and could materially affect the estimated quantities and present value of our proved reserves. In addition, we may adjust estimates of proved reserves to reflect production history, results of exploration and development drilling, results of secondary and tertiary recovery applications, prevailing oil and natural gas prices and other factors, many of which are beyond our control.

Approximately 79% of our total proved reserves as of July 1, 2006 consist of undeveloped and developed non-producing reserves, and those reserves may not ultimately be developed or produced.

Approximately 76% of our total proved reserves are undeveloped and approximately 3% are developed non-producing. While we plan to develop and produce all of our proved reserves, these reserves may not ultimately be developed or produced. Furthermore, not all of our undeveloped or developed non-producing reserves may be ultimately produced at the time periods we have planned, at the costs we have budgeted, or at all.

We may not achieve the production growth we anticipate from properties we acquire.

On May 28, 2004, we acquired Davenport Field Unit, which owned a 100% working interest in certain oil, natural gas and mineral leasehold estates and personal property related such leasehold estates located in Lincoln County, Oklahoma covering approximately 2,178 acres. On July 2, 2004, we acquired all of the outstanding common stock of the Ladder Companies, pursuant to which we acquired interests in 61 wells, including 51 that are located primarily in one field of approximately 4,500 acres in Grant County, Oklahoma. On September 14, 2004, we acquired the Nowata Properties comprised of more than 220 oil and natural gas producing wells on 2,601 acres of land in Nowata County, Oklahoma. On March 29, 2005, we acquired Square One, pursuant to which we own a 100% working interest in 10,300 acres of mature oil fields in central Texas. On November 29, 2005, we acquired all of the outstanding common stock of WO Energy, pursuant to which we own oil and natural gas properties on approximately 20,000 acres in Carson, Gray and Hutchinson counties located in the Texas panhandle with 480 producing wells, 40 water disposal wells and 380 idle wells. On April 28, 2006, our wholly owned subsidiary Pantwist, LLC acquired additional oil and natural gas properties in the Texas panhandle, which properties cover approximately 9,700 acres with 167 wells. Our operational strategy is to implement waterflood and EOR techniques. The performance of waterflood and EOR techniques is often difficult to predict, takes an extended period of time from first investment until actual production and we may not achieve the anticipated production growth from properties we acquire.

Acquisitions may prove to be worth less than we paid because of uncertainties in evaluating recoverable reserves and potential liabilities.

Our recent growth is due in part to acquisitions of exploration and production companies, producing properties and undeveloped leaseholds. We expect acquisitions will also contribute to our future growth. Successful acquisitions require an assessment of a number of factors, including estimates of recoverable reserves, exploration potential, recovery applicability from waterflood and EOR techniques, future oil and natural gas prices, operating costs and potential environmental and other liabilities. Such assessments are inexact and their accuracy is inherently uncertain. In connection with our assessments, we perform a review of the acquired properties which we believe is generally consistent with industry practices. However, such a review will not reveal all existing or potential problems. In addition, our review may not permit us to become sufficiently familiar with the properties to fully assess their deficiencies and capabilities. We do not inspect every well or property. Even when we inspect a well or property, we do not always discover structural,

subsurface and environmental problems that may exist or arise. We are generally not entitled to contractual indemnification for pre-closing liabilities, including environmental liabilities. Normally, we acquire interests in properties on an as is basis with limited remedies for breaches of representations and warranties. As a result of these factors, we may not be able to acquire oil and natural gas properties that contain economically recoverable reserves or be able to complete such acquisitions on acceptable terms.

Additionally, significant acquisitions can change the nature of our operations and business depending upon the character of the acquired properties, which may have substantially different operating and geological characteristics or be in different geographic locations than our existing properties. It is our current intention to continue focusing on acquiring properties with development and exploration potential located in onshore United States. To the extent that we acquire properties substantially different from the properties in our primary operating regions or acquire properties that require different technical expertise, we may not be able to realize the economic benefits of these acquisitions as efficiently as in our prior acquisitions.

Exploration and development drilling and the application of waterflooding and EOR techniques may not result in commercially productive reserves.

We do not always encounter commercially productive reservoirs through our drilling operations or our application of waterflooding or EOR techniques. The new wells we drill or participate in may not be productive and we may not recover all or any portion of our investment in wells we drill or participate in. The seismic data and other technologies we use do not allow us to know conclusively prior to drilling a well that oil or natural gas is present or may be produced economically. The cost of drilling, completing and operating a well is often uncertain, and cost factors can adversely affect the economics of a project. Our efforts will be unprofitable if we drill dry holes or wells that are productive but do not produce enough reserves to return a profit after drilling, operating and other costs or our application of waterflooding or EOR techniques is not successful. Further, our drilling and other operations may be curtailed, delayed or canceled as a result of a variety of factors, including:

- unexpected drilling conditions;
- title problems;
- pressure or irregularities in formations;
- equipment failures or accidents;
- adverse weather conditions; and
- increases in the costs of, or shortages or delays in the availability of, chemicals, drilling rigs and equipment.

The departure of key personnel could adversely affect our ability to run our business.

Our future success is dependent on the personal efforts, performance and abilities of key management, including S. Jeffrey Johnson, our Chairman and Chief Executive Officer; Morris B. Smith, Senior Vice President and Chief Financial Officer; Patrick McKinney, Senior Vice President Engineering and Operations; James K. Teringo, Jr., Senior Vice President, General Counsel and Secretary; and Michael J. Ricketts, Vice President and Principal Accounting Officer. All of these individuals are integral parts of our daily operations. We have employment agreements with Messrs. Johnson, Smith, McKinney, Teringo and Ricketts. We do not maintain any key life insurance policies for any of our executive officers or other personnel. Although, to our knowledge, none of our senior management currently has any plans to retire or leave our company in the near

future, the loss of any of them could significantly impact our business until adequate replacements can be identified and put in place.

We face strong competition from larger oil and natural gas companies, which makes it difficult to conduct profitable operations.

Our competitors include major integrated oil and natural gas companies and numerous independent oil and natural gas companies, individuals and drilling and income programs. Many of these competitors are large, well-established companies and have substantially larger operating staffs and greater capital resources than we do. We may not be able to successfully conduct our operations, evaluate and select suitable properties and consummate transactions in this highly competitive environment. Specifically, these larger competitors may be able to pay more for exploratory prospects and productive oil and natural gas properties and may be able to define, evaluate, bid for and purchase a greater number of properties and prospects than our financial or human resources permit. In addition, such companies may be able to expend greater resources on the existing and changing technologies that we believe are and will be increasingly important to attaining success in the industry.

We are subject to many restrictions under our revolving credit facility which may adversely impact our future operations.

We may depend on our revolving credit facility for future capital needs. As required by our revolving credit facility with our bank lenders, we have pledged substantially all of our oil and natural gas properties as collateral to secure the payment of our indebtedness. The revolving credit facility restricts our ability to obtain additional financing, make investments, sell assets, grant liens, repurchase, redeem or retire our securities, enter into specific transactions with our subsidiaries or affiliates and engage in business combinations. The revolving credit facility prohibits us from declaring or paying dividends on our common stock. We are also required to comply with certain financial covenants and ratios.

These financial covenants and ratios could limit our ability to obtain future financing, make needed capital expenditures, withstand a downturn in our business or economy in general or otherwise conduct necessary corporate activities. We may also be prevented from taking advantage of business opportunities that arise because of the limitations that the restrictive covenants under the revolving credit facility impose on us. Although we are currently in compliance with these covenants, in the past we have had to request waivers from or enter into amendments with our lenders to avoid default because of our anticipated non-compliance with certain financial covenants and ratios. Any future default, if not cured or waived, could result in the acceleration of all indebtedness outstanding under the revolving credit facility. If that should occur, we may not be able to pay all such debt or to borrow sufficient funds to refinance it. Even if new financing were available, it may not be on terms that are acceptable to us.

In addition, the revolving credit facility limits the amounts we can borrow to a borrowing base amount, determined by the lenders, based upon projected revenues from the oil and natural gas properties securing our loan. The lenders can independently adjust the borrowing base and the borrowings permitted to be outstanding under the revolving credit facility.

Derivative activities create a risk of financial loss.

Pursuant to the terms of our senior credit facility, we are parties to oil and natural gas price risk management arrangements with respect to a portion of our expected production. We purchase floors that generally result in minimum price received by us for a portion of our production over a specified time period. We have the right to receive from the counterparty, the excess of the fixed price specified in the contract over a floating price based on a market index, multiplied by the

quantity identified in the derivative contract. These transactions may expose us to the risk of financial loss if the counterparties to our future contracts fail to perform under the contracts.

Failure to maintain effective internal controls could have a material adverse effect on our operations.

Beginning with our fiscal year ending June 30, 2007, we will be subject to Section 404 of the Sarbanes-Oxley Act which requires annual management assessments of the effectiveness of our internal control over financial reporting and a report by our independent auditors addressing our internal controls and management's assessment. Effective internal controls are necessary for us to produce reliable financial reports. If, as a result of deficiencies in our internal controls, we cannot provide reliable financial reports, our business decision process may be adversely affected, our business and operating results could be harmed, we may be in violation of our lending covenants, investors could lose confidence in our reported financial information, and the price of our stock could decrease as a result.

During our evaluation of disclosure controls and procedures for the year ended June 30, 2006, we concluded that our disclosure controls and procedures were not effective to ensure that all information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934, as amended, is: (i) accumulated and communicated to our management, including our chief executive officer, chief financial officer and principal accounting officer, as appropriate, to allow timely decisions regarding required disclosure; and (ii) recorded, processed, summarized and reported, with the time periods specified by the Securities and Exchange Commission's rules and forms. This specifically pertained to the preparation and review of deferred tax liabilities and the related deferred income tax benefit. Our internal controls have been strengthened through increased review and communication between us and the third-party that assists us with our deferred tax calculations which began during the preparation of the income tax accrual for the quarter ended September 30, 2006.

During the course of performing our quarter end closing procedures as of September 30, 2006, our internal controls detected that a senior executive was involved in fraudulent sales to Cano of equipment and materials. In the opinion of management, failure to set up adequate controls over payments to vendors represents a material weakness in the Company's internal control over financial reporting as of September 30, 2006. We have implemented additional procedures to strengthen our internal controls over accounts payable processing subsequent to September 30, 2006. The additional procedures involve additional procedures to set-up new vendors in our accounts payable system and additional review and approval of vendor invoices prior to payment.

There can be no guarantee that we will not have deficiencies in our internal controls in the future.

Our business involves many operating risks, which may result in substantial losses, and insurance may be unavailable or inadequate to protect us against these risks.

Our operations are subject to hazards and risks inherent in drilling for, producing and transporting oil and natural gas, such as:

- fires;
- natural disasters;
- explosions;
- pressure forcing oil or natural gas out of the wellbore at a dangerous velocity coupled with the potential for fire or explosion;
- weather;

- failure of oilfield drilling and service tools;
- changes in underground pressure in a formation that causes the surface to collapse or crater;
- pipeline ruptures or cement failures;
- environmental hazards such as natural gas leaks, oil spills and discharges of toxic gases; and
- availability of needed equipment at acceptable prices, including steel tubular products.

Any of these risks can cause substantial losses resulting from:

- injury or loss of life;
- damage to and destruction of property, natural resources and equipment;
- pollution and other environmental damage;
- regulatory investigations and penalties;
- suspension of our operations; and
- repair and remediation costs.

Our liability for environmental hazards includes those created either by the previous owners of properties that we purchase or lease or by acquired companies prior to the date we acquire them. We maintain insurance against some, but not all, of the risks described above. Our insurance policies currently provide for \$1,000,000 general liability coverage for bodily injury and property damage including pollution, underground resources, blow out and cratering. In addition, we have \$250,000 coverage for our contractual obligations to our service contractors using their equipment downhole. We have a Hired and Non-Owned Commercial Automobile liability limit of \$1,000,000. We also have secured \$25,000,000 umbrella coverage in excess of the general liability and automobile liability. Our insurance may not be adequate to cover casualty losses or liabilities. Also, in the future we may not be able to obtain insurance at premium levels that justify its purchase.

We do not insure against the loss of oil or natural gas reserves as a result of operating hazards, insure against business interruption or insure our field production equipment against loss. Losses could occur for uninsurable or uninsured risks, or in amounts in excess of existing insurance coverage. The occurrence of an event that is not fully covered by insurance could harm our financial condition and results of operations.

There are risks in acquiring producing properties, including difficulties in integrating acquired properties into our business, additional liabilities and expenses associated with acquired properties, diversion of management attention, increasing the scope, geographic diversity and complexity of our operations and incurrence of additional debt.

Our business strategy includes growing our reserve base through acquisitions. Our failure to integrate acquired businesses successfully into our existing business, or the expense incurred in consummating future acquisitions, could result in unanticipated expenses and losses. In addition, we may assume cleanup or reclamation obligations or other unanticipated liabilities in connection with these acquisitions. The scope and cost of these obligations may ultimately be materially greater than estimated at the time of the acquisition.

We are continually investigating opportunities for acquisitions. In connection with future acquisitions, the process of integrating acquired operations into our existing operations may result in unforeseen operating difficulties and may require significant management attention and financial resources that would otherwise be available for the ongoing development or expansion of existing

operations. Our ability to make future acquisitions may be constrained by our ability to obtain additional financing.

Possible future acquisitions could result in our incurring additional debt, contingent liabilities and expense, all of which could have a material adverse effect on our financial condition and operating results.

Terrorist activities may adversely affect our business.

Terrorist activities, including events similar to those of September 11, 2001, or armed conflict involving the United States may adversely affect our business activities and financial condition. If events of this nature occur and persist, the resulting political and social instability could adversely affect prevailing oil and natural gas prices and cause a reduction in our revenues. In addition, oil and natural gas production facilities, transportation systems and storage facilities could be direct targets of terrorist attacks, and our operations could be adversely impacted if infrastructure integral to our operations is destroyed or damaged. Costs associated with insurance and other security measures may increase as a result of these threats, and some insurance coverage may become more difficult to obtain, if available at all.

Part of our business is seasonal in nature which may affect the price of our oil and natural gas.

Weather conditions affect the demand for and price of oil and natural gas. Demand for oil and natural gas is typically higher during winter months than summer months. However, warm winters can also lead to downward price trends. As a result, our results of operations may be adversely affected by seasonal conditions.

We are subject to potential early repayments as well as restrictions pursuant to the terms of our Series D Convertible Preferred Stock which may adversely impact our operations.

Pursuant to the terms of our Series D Convertible Preferred Stock, if a triggering event occurs, the holders of our Series D Convertible Preferred Stock will have the right to require us to redeem their preferred stock at a minimum price of at least 125% of the \$1,000 per share stated value plus certain dividends. Triggering events include the following:

- our common stock is suspended from trading or fails to be listed on the AMEX, the New York Stock Exchange, the Nasdaq Global Select Market, the Nasdaq Global Market or the Nasdaq Capital Market;
- we fail to convert and do not cure this failure within 10 business days after the conversion date or give notice of our intention not to comply with a request for conversion;
- we fail to pay for at least 5 business days any amount when and as due pursuant to the terms of the Series D Convertible Preferred Stock or any documents related to the sale and registration rights of the Series D Convertible Preferred Stock, common stock and warrants;
- certain actions are taken by us or third parties with regard to bankruptcy;
- we default on any indebtedness which default is not waived and the applicable grace period has expired; or
- we breach any representation, warranty, covenant or other term or condition of any document relating to the sale and registration rights regarding the Series D Convertible Preferred