FOREST OIL CORP
Form 10-Q
November 09, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

Or

o 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 1-13515

FOREST OIL CORPORATION

(Exact name of registrant as specified in its charter)

New York (State or other jurisdiction of incorporation or organization)	**25-0484900** (I.R.S. Employer Identification No.)
707 17th Street, Suite 3600 Denver, Colorado (Address of principal executive offices)	**80202** (Zip Code)

Registrant s telephone number, including area code: **(303) 812-1400**

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. x Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer o Non-accelerated filer o

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

As of October 31, 2006 there were 62,931,547 shares of the registrant s common stock, par value $.10 per share, outstanding.

FOREST OIL CORPORATION
INDEX TO FORM 10-Q
September 30, 2006

PART I - FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

FOREST OIL CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In Thousands, Except Share Data)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 11,402	7,231
Accounts receivable	119,918	178,124
Derivative instruments	37,499	941
Deferred tax assets		77,346
Other current assets	34,588	52,283
Total current assets	203,407	315,925
Property and equipment, at cost:		
Oil and gas properties, full cost method of accounting:		
Proved, net of accumulated depletion of $2,220,480 and $3,059,031	2,435,869	2,898,774
Unproved	259,842	275,684
Net oil and gas properties	2,695,711	3,174,458
Other property and equipment, net of accumulated depreciation and amortization of $31,329 and $32,527	31,850	25,560
Net property and equipment	2,727,561	3,200,018
Derivative instruments	19,413	
Goodwill	86,880	87,072
Other assets	34,108	42,531
	$ 3,071,369	3,645,546
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 231,150	312,076
Accrued interest	18,242	4,260
Derivative instruments	14,781	151,678
Asset retirement obligations	1,800	33,329
Deferred income taxes	4,183	
Other current liabilities	14,745	21,573
Total current liabilities	284,901	522,916
Long-term debt	1,096,076	884,807
Asset retirement obligations	58,948	178,225
Other liabilities	43,436	45,691
Deferred income taxes	180,800	329,385
Total liabilities	1,664,161	1,961,024
Shareholders equity:		
Preferred stock, none issued		
Common stock, 62,927,258 and 64,548,229 shares issued and outstanding	6,293	6,455
Capital surplus	1,211,519	1,529,102
Retained earnings	106,947	217,293
Accumulated other comprehensive income (loss)	82,449	(18,220)
Treasury stock, at cost, 1,861,143 shares held in 2005		(50,108)
Total shareholders equity	1,407,208	1,684,522
	$ 3,071,369	3,645,546

See accompanying Notes to Condensed Consolidated Financial Statements.

FOREST OIL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
	(In Thousands, Except Per Share Amounts)			
Revenue:				
Oil and gas sales:				
Natural gas	$ 90,296	156,070	312,102	470,711
Oil, condensate, and natural gas liquids	110,624	110,080	318,137	323,664
Total oil and gas sales	200,920	266,150	630,239	794,375
Marketing, processing, and other	1,919	2,086	5,899	5,207
Total revenue	202,839	268,236	636,138	799,582
Operating expenses:				
Lease operating expenses	34,963	51,576	115,823	145,219
Production and property taxes	8,974	10,914	30,699	31,358
Transportation costs	5,494	4,597	15,865	14,352
General and administrative (including stock-based compensation)	10,548	9,847	38,755	31,694
Depreciation and depletion	62,505	91,029	203,426	284,554
Accretion of asset retirement obligations	1,226	4,352	5,879	12,951
Impairments and other		4,002	2,078	6,926
Spin-off and merger costs			5,416	
Total operating expenses	123,710	176,317	417,941	527,054
Earnings from operations	79,129	91,919	218,197	272,528
Other income and expense:				
Interest expense	19,122	15,664	51,613	46,224
Unrealized (gains) losses on derivative instruments, net	(77,914)	72,095	(68,178)	74,365
Realized losses (gains) on derivative instruments, net	12,883	38	30,496	(280)
Unrealized foreign currency exchange loss	766		766	
Other (income) expense, net	(950)	341	(200)	4,251
Total other income and expense	(46,093)	88,138	14,497	124,560
Earnings before income taxes and discontinued operations	125,222	3,781	203,700	147,968
Income tax expense:				
Current	(743)	(203)	2,078	1,971
Deferred	49,031	719	66,391	51,660
Total income tax expense	48,288	516	68,469	53,631
Earnings from continuing operations	76,934	3,265	135,231	94,337
Income from discontinued operations, net of tax			2,422	
Net earnings	$ 76,934	3,265	137,653	94,337
Basic earnings per common share:				
Earnings from continuing operations	$ 1.24	.05	2.17	1.54
Income from discontinued operations, net of tax			.04	
Net earnings per common share	$ 1.24	.05	2.21	1.54
Diluted earnings per common share:				
Earnings from continuing operations	$ 1.21	.05	2.13	1.50
Income from discontinued operations, net of tax			.04	
Net earnings per common share	$ 1.21	.05	2.17	1.50

See accompanying Notes to Condensed Consolidated Financial Statements.

FOREST OIL CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY
(Unaudited)

	Common Stock Shares (In Thousands)	Amount	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Treasury Stock	Total Shareholders Equity
Balances at January 1, 2006	64,548	$ 6,455	1,529,102	217,293	(18,220)	(50,108)	1,684,522
Exercise of stock options	218	22	4,649	(8)		27	4,690
Tax benefit of stock options exercised			40				40
Employee stock purchase plan	20	2	553				555
Restricted stock issued, net of forfeitures	1						
Retirement of treasury stock	(1,860)	(186)	(49,895)			50,081	
Amortization of stock-based compensation			17,017				17,017
Tax benefit of acquired net operating losses			8,405				8,405
Pro rata distribution of MERI common stock to shareholders (Note 2)			(298,352)	(247,991)	7,549		(538,794)
Comprehensive earnings:							
Net earnings				137,653			137,653
Unrealized gain on effective derivative instruments, net of tax					77,074		77,074
Amortization of deferred hedging loss, net of tax					2,411		2,411
Decrease in unfunded pension liability, net of tax					83		83
Foreign currency translation					13,552		13,552
Total comprehensive earnings							230,773
Balances at September 30, 2006	62,927	$ 6,293	1,211,519	106,947	82,449		1,407,208

See accompanying Notes to Condensed Consolidated Financial Statements.

FOREST OIL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30, 2006 (In Thousands)	2005
Operating activities:		
Net earnings	$ 137,653	94,337
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and depletion	203,426	284,554
Accretion of asset retirement obligations	5,879	12,951
Stock-based compensation	11,384	426
Impairments	2,078	2,924
Unrealized (gains) losses on derivative instruments, net	(68,178)	74,365
Amortization of deferred derivative losses	15,204	
Unrealized foreign currency exchange loss	766	
Deferred income tax expense	67,617	51,660
Other, net	(2,565)	1,883
Changes in operating assets and liabilities, net of effects of acquisitions and divestitures:		
Accounts receivable	966	(645)
Other current assets	(23,330)	(3,956)
Accounts payable	(1,131)	(6,859)
Accrued interest and other current liabilities	(3,153)	6,792
Net cash provided by operating activities	346,616	518,432
Investing activities:		
Capital expenditures for property and equipment:		
Exploration, development, and acquisition costs	(741,495)	(548,133)
Other fixed assets	(9,718)	(9,659)
Proceeds from sales of assets	1,367	23,668
Other, net	120	(4,273)
Net cash used by investing activities	(749,726)	(538,397)
Financing activities:		
Proceeds from bank borrowings	2,444,963	1,630,000
Repayments of bank borrowings	(2,055,924)	(1,663,000)
Repayments of bank debt assumed in acquisition		(35,000)
Proceeds from Spin-off (Note 2)	21,670	
Proceeds from the exercise of options and warrants and employee stock purchases	5,246	41,806
Other, net	(8,599)	(1,723)
Net cash provided (used) by financing activities	407,356	(27,917)
Effect of exchange rate changes on cash	(75)	(780)
Net increase (decrease) in cash and cash equivalents	4,171	(48,662)
Cash and cash equivalents at beginning of period	7,231	55,251
Cash and cash equivalents at end of period	$ 11,402	6,589
Cash paid during the period for:		
Interest	$ 42,819	35,235
Income taxes	5,243	5,128

See accompanying Notes to Condensed Consolidated Financial Statements.

FOREST OIL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) BASIS OF PRESENTATION

The Condensed Consolidated Financial Statements included herein are unaudited and include the accounts of Forest Oil Corporation and its consolidated subsidiaries (collectively, Forest or the Company). In the opinion of management, all adjustments, consisting of normal recurring accruals, have been made which are necessary for a fair presentation of the financial position of Forest at September 30, 2006, the results of its operations for the three and nine months ended September 30, 2006 and 2005, and its cash flows for the nine months ended September 30, 2006 and 2005. Interim results are not necessarily indicative of expected annual results because of the impact of fluctuations in prices received for liquids (oil, condensate, and natural gas liquids) and natural gas and other factors.

In the course of preparing the Condensed Consolidated Financial Statements, management makes various assumptions, judgments, and estimates to determine the reported amount of assets, liabilities, revenue, and expenses, and in the disclosures of commitments and contingencies. Changes in these assumptions, judgments, and estimates will occur as a result of the passage of time and the occurrence of future events and, accordingly, actual results could differ from amounts initially established.

The more significant areas requiring the use of assumptions, judgments, and estimates relate to volumes of oil and gas reserves used in calculating depletion, the amount of future net revenues used in computing the ceiling test limitations, and the amount of future capital costs and abandonment obligations used in such calculations. Assumptions, judgments, and estimates are also required in determining impairments of undeveloped properties, valuing deferred tax assets, and estimating fair values of derivative instruments.

Certain amounts in the prior year financial statements have been reclassified to conform to the 2006 financial statement presentation.

For a more complete understanding of Forest s operations, financial position, and accounting policies, reference is made to the consolidated financial statements of Forest, and related notes thereto, filed with Forest s annual report on Form 10-K for the year ended December 31, 2005, previously filed with the Securities and Exchange Commission.

(2) ACQUISITIONS AND DIVESTITURES

Acquisitions

On March 31, 2006, Forest completed the acquisition of oil and gas properties located primarily in the Cotton Valley trend in East Texas. Forest paid approximately $255 million, as adjusted to reflect an economic effective date of February 1, 2006, for properties with an estimated 110 Bcfe of estimated proved reserves at the time the acquisition was announced in February 2006 and production that averaged 13 MMcfe per day in January 2006. Forest acquired approximately 26,000 net acres in the fields, of which approximately 14,000 net acres were undeveloped. Forest funded this acquisition utilizing its bank credit facilities.

Divestitures

Spin-off and Merger of Offshore Gulf of Mexico Operations

On March 2, 2006, Forest completed the spin-off of its offshore Gulf of Mexico operations by means of a special dividend, which consisted of a pro rata spin-off (the Spin-off) of all outstanding shares of Forest Energy Resources, Inc. (hereinafter known as Mariner Energy Resources, Inc. or MERI), a total

(2) ACQUISITIONS AND DIVESTITURES (Continued)

of 50,637,010 shares of common stock, to holders of record of Forest common stock as of the close of business on February 21, 2006. Immediately following the Spin-off, MERI was merged with a subsidiary of Mariner Energy, Inc. (Mariner) in a stock for stock transaction (the Merger). Mariner s common stock commenced trading on the New York Stock Exchange on March 3, 2006.

The Spin-off was a tax-free transaction for federal income tax purposes. Prior to the Merger, as part of the Spin-off, MERI paid Forest approximately $176.1 million. The $176.1 million was drawn on a newly created bank credit facility established by MERI immediately prior to the Spin-off. This credit facility and associated liability was included in the Spin-off. Subsequent to the closing, Forest received additional net cash proceeds of $21.7 million from MERI for a total of $197.8 million. As of October 31, 2006, in accordance with the transaction agreements, Forest and MERI had submitted post-closing adjustments from which Forest has determined it owes MERI approximately $5.8 million, which is subject to further adjustment.

The table below sets forth the effect of the Spin-off on the Company s balance sheet:

	Change in Balance Sheet Accounts (In Thousands)		
Assets (Increase/(Decrease))			
Cash	$	(10	)
Accounts receivable Due from MERI	15,953		
Accounts receivable third parties	(54,078		)
Other current assets	(44,837		)
Proved oil and gas properties, net of accumulated depletion	(1,033,289		)
Unproved oil and gas properties	(38,523		)
Other assets	(7,919		)
Liabilities and Shareholders Equity ((Increase)/Decrease)			
Current liabilities	96,142		
Derivative instruments	17,087		
MERI credit facility	176,102		
Asset retirement obligations	150,182		
Deferred income taxes	184,396		
Accumulated other comprehensive income	(7,549		)
Net decrease to capital surplus and retained earnings	$	(546,343	)

Sale of ProMark Discontinued Operations

On March 1, 2004, the Company sold the assets and business operations of Producers Marketing, Ltd. (ProMark) to Cinergy Canada, Inc. (Cinergy) for $11.2 million CDN. As a result of the sale, ProMark s results of operations were reported as discontinued operations in the historical financial statements. Under the terms of the purchase and sale agreement, Forest may receive additional contingent consideration over a period of five years through February 2009. During the nine months ended September 30, 2006, Forest recognized an additional $3.6 million contingent payment ($2.4 million net of tax), which has been reflected as income from discontinued operations in the Condensed Consolidated Statements of Operations.

(3) EARNINGS PER SHARE AND COMPREHENSIVE EARNINGS (LOSS)

Earnings per Share

Basic earnings per share is computed by dividing net earnings attributable to common stock by the weighted average number of common shares outstanding during each period, excluding treasury shares.

Diluted earnings per share is computed by adjusting the average number of common shares outstanding for the dilutive effect, if any, of stock options, unvested restricted stock grants, unvested phantom stock units, and warrants. The following sets forth the calculation of basic and diluted earnings per share:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
	(In Thousands, Except Per Share Amounts)			
Earnings from continuing operations	$76,934	3,265	135,231	94,337
Income from discontinued operations, net of tax			2,422	
Net earnings	$76,934	3,265	137,653	94,337
Weighted average common shares outstanding during the period	62,250	61,946	62,187	61,198
Add dilutive effects of stock options, unvested restricted stock grants, and unvested phantom stock units	1,234	1,194	1,194	1,077
Add dilutive effects of warrants				432
Weighted average common shares outstanding, including the effects of dilutive securities	63,484	63,140	63,381	62,707
Basic earnings per share:				
From continuing operations	$1.24	.05	2.17	1.54
From discontinued operations			.04	
Basic earnings per share	$1.24	.05	2.21	1.54
Diluted earnings per share:				
From continuing operations	$1.21	.05	2.13	1.50
From discontinued operations			.04	
Diluted earnings per share	$1.21	.05	2.17	1.50

Comprehensive Earnings (Loss)

Comprehensive earnings (loss) is a term used to refer to net earnings plus other comprehensive income (loss). Other comprehensive income (loss) is comprised of revenues, expenses, gains, and losses that under generally accepted accounting principles are reported as separate components of shareholders equity instead of net earnings. Items included in Forest s other comprehensive income (loss) for the three and nine months ended September 30, 2006 and 2005 are foreign currency gains related to the translation of the assets and liabilities of Forest s Canadian operations, changes in the unfunded pension liability, and net hedging losses.

The components of comprehensive earnings (loss) are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
	(In Thousands)			
Net earnings	$76,934	3,265	137,653	94,337
Other comprehensive income (loss):				
Foreign currency translation gains	294	18,257	13,552	11,367
Unfunded pension liability, net of tax			83	(149)
Unrealized gain (loss) on derivative instruments, net of tax	1,381	(56,454)	79,485	(104,713)
Total comprehensive earnings (loss)	$78,609	(34,932)	230,773	842

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(4) STOCK-BASED COMPENSATION

Prior to January 1, 2006, the Company accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Under APB Opinion No. 25, no compensation expense was recognized for stock options issued to employees if the grant price equaled or was above the market price on the date of the option grant. Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (Revised), *Share-Based Payment* (SFAS 123(R)) using the modified prospective method. Under this method, compensation cost is recorded for all unvested stock options, restricted stock, and phantom stock units beginning in the period of adoption and prior period financial statements are not restated. Under the fair value recognition provisions of SFAS 123(R), stock-based compensation is measured at the grant date based on the value of the awards and the value is recognized on a straight-line basis over the requisite service period (usually the vesting period).

The table below sets forth total stock-based compensation recorded during the three and nine months ended September 30, 2006 under the provisions of SFAS 123(R), the remaining unamortized amounts and the weighted average amortization period remaining as of September 30, 2006. Approximately $9.7 million of the $18.7 million of total stock-based compensation for the nine months ended September 30, 2006 was attributable to a partial settlement of the Company s restricted stock awards and phantom stock unit awards in connection with the Spin-off.

	Stock Options	**Restricted Stock**	**Phantom Stock Units**	**Total** (1)
	(In Thousands)			
Three months ended September 30, 2006:				
Total stock-based compensation costs	$ 961	1,305	162	2,428
Less: stock-based compensation costs capitalized	(425)	(398)	(96)	(919)
Stock-based compensation costs expensed	$ 536	907	66	1,509
Nine months ended September 30, 2006:				
Total stock-based compensation costs	$ 3,983	12,827	1,682	18,492
Less: stock-based compensation costs capitalized	(1,135)	(4,684)	(944)	(6,763)
Stock-based compensation costs expensed	$ 2,848	8,143	738	11,729
Unamortized stock-based compensation costs as of September 30, 2006	$ 7,021	13,680	2,456 (2)	23,157
Weighted average amortization period remaining	1.1 years	2.1 years	2.3 years	1.8 years

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(1) The Company also maintains an employee stock purchase plan (which is not included in the table above) under which $.1 million and $.2 million of compensation cost was recognized for the three and nine months ended September 30, 2006, respectively under the provisions of SFAS 123(R).

(2) Based on the closing price of the Company s common stock on September 30, 2006.

SFAS 123(R) required the Company to estimate forfeitures in calculating the cost related to stock-based compensation as opposed to recognizing forfeitures and the corresponding reduction in expense as the forfeitures occur. The cumulative adjustment recorded related to this change of approximately $.1 million was recorded as a reduction in general and administrative expense and capitalized oil and gas properties in the first quarter of 2006 and was not presented separately in the Condensed Consolidated Statement of Operations. The impact of adopting SFAS 123(R) as of January 1, 2006 resulted in a decrease to net income of approximately $1.9 million, or $.03 per basic and diluted share for the nine month period ending September 30, 2006.

(4) STOCK-BASED COMPENSATION (Continued)

Equity Incentive Plans

In 2001, the Company adopted the Forest Oil Corporation 2001 Stock Incentive Plan (the 2001 Plan) under which non-qualified stock options, incentive stock options, restricted stock, phantom stock units, and other awards may be granted to employees, consultants, and non-employee directors. In 2003, the Company amended the 2001 Plan to increase the number of shares of the Company s common stock, at par value $.10 per share (Common Stock), reserved for issuance. The aggregate number of shares of Common Stock that the Company may issue under the 2001 Plan may not exceed 5,012,074 shares. Options have historically been granted at an exercise price equal to the fair market value of one share of Common Stock on the date of grant. Options granted to employees under the 2001 Plan generally vest in increments of 25% on each of the first four anniversary dates of the date of grant and have a term of ten years. Options granted to non-employee directors vest immediately and have a term of ten years. In connection with the Spin-off, the shares available for grant and outstanding stock options under the 2001 Plan were adjusted to reflect the economic effect of the Spin-off by reducing the exercise price and increasing the number of underlying shares. As of September 30, 2006, the Company had 649,728 shares available for issuance under the 2001 Plan.

The Company also had a Stock Incentive Plan (the 1996 Plan) that expired on March 5, 2002 under which non-qualified stock options and restricted stock were granted to employees and director stock awards were granted to non-employee directors. Options granted under the 1996 Plan generally vested in increments of 20% commencing on the date of grant and on each of the first four anniversaries of the date of the grant and generally had a term of ten years.

The Company has historically issued new shares of Common Stock or treasury stock to settle its equity-based awards. In May 2006, Forest retired the Company s treasury stock. As a result of the retirement, settlements on equity-based awards subsequent to May 2006 will be from issuances of new shares of Common Stock.

(4) STOCK-BASED COMPENSATION (Continued)

Stock Options

The following table summarizes stock option activity in the Company s stock-based compensation plans for the nine months ended September 30, 2006. The number of shares and the exercise price of the outstanding stock options were adjusted so that the fair value of each award was the same immediately before and after the Spin-off, in accordance with the anti-dilution provisions in the 2001 Plan and 1996 Plan.

	Number of Options	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value (In Thousands)(1)	Number of Shares Exercisable
Outstanding at January 1, 2006	2,578,235	$ 27.78	$ 45,889	1,348,599
Granted				
Exercised	(58,337)	28.71	1,255	
Cancelled	(98,587)	30.91		
Outstanding at March 2, 2006	2,421,311	27.63	55,723	
Adjustment to give effect to Spin-off	1,176,804			
Granted	50,000	36.95		
Exercised	(160,837)	18.75	2,536	
Cancelled	(74,979)	20.87		
Outstanding at September 30, 2006	3,412,299	18.80	43,771	2,205,889

(1) The intrinsic value of a stock option is the amount by which the current market value of the underlying stock exceeds the exercise price of the option.

Stock options are granted at the fair market value of one share of Common Stock on the date of grant. Options granted to non-employee directors vest immediately and options granted to officers and other employees vest ratably over four years. All outstanding options had a term of ten years at the date of grant.

The fair value of stock options granted during 2006 was estimated using the Black-Scholes option pricing model. The following weighted average assumptions were used to compute the fair market value of stock options granted in the nine months ended September 30, 2006 and 2005:

		Nine Months Ended September 30,	