

VAALCO ENERGY INC /DE/
Form 10QSB
August 13, 2004
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

(Mark One)

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

For the quarterly period ended June 30, 2004

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 0-20928

VAALCO Energy, Inc.

(Exact name of small business issuer as specified in its charter)

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| | |
|--|--|
| Delaware (State or other jurisdiction of incorporation or organization) | 76-0274813 (I.R.S. Employer Identification No.) |
| 4600 Post Oak Place Suite 309 | |
| Houston, Texas (Address of principal executive offices) | 77027 (Zip code) |
| (Issuer's telephone number, including area code) (713) 623-0801 | |

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No .

As of August 13, 2004, there were outstanding 30,621,726 shares of Common Stock, \$0.10 par value per share, of the registrant. In addition, as of such date there were outstanding 6,666-2/3 shares of Preferred Stock which are convertible into 18,333,334 shares of Common Stock.

Transitional Small Business Disclosure Format (Check one) Yes No .

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VAALCO ENERGY, INC. AND SUBSIDIARIES

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| | June 30, 2004 | December 31, 2003 |
|--|--------------------------|------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 22,488 | \$ 22,995 |
| Funds in escrow | 1,147 | 2,144 |
| Receivables: | | |
| Trade | 7 | 58 |
| Accounts with partners | 1,644 | |
| Other | 279 | 449 |
| Crude oil inventory | 1,173 | 586 |
| Materials and supplies | 197 | 271 |
| Prepayments and other | 1,203 | 533 |
| Current assets of discontinued operations | 87 | 491 |
| | <u>28,225</u> | <u>27,527</u> |
| Property and equipment – successful efforts method: | | |
| Wells, platforms and other production facilities | 22,706 | 23,393 |
| Work in progress | 11,709 | 1,905 |
| Equipment and other | 1,119 | 593 |
| | <u>35,534</u> | <u>25,891</u> |
| Accumulated depreciation, depletion and amortization | (10,974) | (9,282) |
| | <u>24,560</u> | <u>16,609</u> |
| Other assets: | | |
| Deferred tax asset | 1,025 | 920 |
| Funds in escrow | 803 | 801 |
| Long term assets of discontinued operations | | 14 |
| Other long-term assets | 401 | 496 |
| | <u>2,229</u> | <u>1,231</u> |
| TOTAL | \$ 55,014 | \$ 46,367 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | \$ 12,214 | \$ 6,019 |
| Accounts with partners | | 3,015 |
| Current portion of long term debt | 2,750 | 4,000 |
| Current liabilities of discontinued operations | | 1,364 |
| Income taxes payable | | 45 |
| | <u>15,014</u> | <u>14,443</u> |

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| | | |
|---|-------------------|-------------------|
| Total current liabilities | 14,964 | 14,443 |
| Long term liabilities of discontinued operations | | 1,538 |
| Long term debt | 2,500 | 3,000 |
| Asset retirement obligations | 1,200 | 1,165 |
| | <u> </u> | <u> </u> |
| Total liabilities | 18,664 | 20,146 |
| | <u> </u> | <u> </u> |
| Commitments and contingencies: | | |
| Minority interest in consolidated subsidiaries | 2,665 | 1,667 |
| Stockholders' equity: | | |
| Convertible preferred stock, \$25 par value, 500,000 shares authorized; 10,000 shares issued and outstanding | 250 | 250 |
| Common stock, \$0.10 par value, 100,000,000 authorized shares 21,606,829 and 21,531,829 shares issued with 151,769 in treasury at June 30, 2004 and December 31, 2003, respectively | 2,161 | 2,153 |
| Additional paid-in capital | 46,373 | 46,358 |
| Accumulated deficit | (14,924) | (24,032) |
| Less treasury stock, at cost | (175) | (175) |
| | <u> </u> | <u> </u> |
| Total stockholders' equity | 33,685 | 24,554 |
| | <u> </u> | <u> </u> |
| TOTAL | \$ 55,014 | \$ 46,367 |
| | <u> </u> | <u> </u> |

See notes to consolidated financial statements.

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VAALCO ENERGY, INC. AND SUBSIDIARIES
STATEMENTS OF CONSOLIDATED OPERATIONS

(Unaudited)

(in thousands of dollars, except per share amounts)

| | Three months ended June 30, | | Six months ended June 30, | |
|--|--------------------------------|----------|------------------------------|-----------|
| | 2004 | 2003 | 2004 | 2003 |
| Revenues: | | | | |
| Oil and gas sales | \$ 11,608 | \$ 6,955 | \$ 19,768 | \$ 15,312 |
| Total revenues | 11,608 | 6,955 | 19,768 | 15,312 |
| Operating costs and expenses: | | | | |
| Production expenses | 2,181 | 1,724 | 4,128 | 3,269 |
| Exploration expense | 26 | 73 | 142 | 122 |
| Depreciation, depletion and amortization | 914 | 1,508 | 1,727 | 3,017 |
| General and administrative expenses | 220 | 229 | 208 | 876 |
| Total operating costs and expenses | 3,341 | 3,534 | 6,205 | 7,284 |
| Operating income | 8,267 | 3,421 | 13,563 | 8,028 |
| Other income (expense): | | | | |
| Interest income | 52 | 17 | 100 | 32 |
| Interest expense | (122) | (1,677) | (257) | (2,265) |
| Other, net | 27 | 28 | 55 | 6 |
| Total other income (expense) | (43) | (1,632) | (102) | (2,227) |
| Income from continuing operations before income taxes, minority interest and cumulative effect of accounting change | 8,224 | 1,789 | 13,461 | 5,801 |
| Income tax expense | 1,936 | 1,069 | 3,280 | 2,353 |
| Income from continuing operations before minority interest and cumulative effect of accounting change | 6,288 | 720 | 10,181 | 3,448 |
| Discontinued operations: (Note 6) | | | | |
| Income (loss) from discontinued operations net of tax | 146 | (8) | (60) | (80) |
| Income from gain on disposal of discontinued operations | 83 | | 83 | |
| Income (loss) on discontinued operations | 229 | (8) | 23 | (80) |
| Minority interest in earnings of subsidiaries | (662) | (247) | (1,096) | (639) |
| Cumulative effect of accounting change | | | | 1,717 |
| Net income attributable to common shareholders | \$ 5,855 | \$ 465 | \$ 9,108 | \$ 4,446 |
| | \$ 0.26 | \$ 0.02 | \$ 0.42 | \$ 0.13 |

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| | | | | |
|--|----------------|---------|----------------|---------|
| Basic income per common share from continuing operations before cumulative effect of accounting change | | | | |
| Income from discontinued operations | 0.01 | | | |
| Cumulative effect of accounting changes | | | | 0.08 |
| Basic income per common share | \$ 0.27 | \$ 0.02 | \$ 0.42 | \$ 0.21 |
| Diluted income per common share from continuing operations before cumulative effect of accounting change | \$ 0.10 | \$ 0.01 | \$ 0.16 | \$ 0.05 |
| Income from discontinued operations | | | | |
| Cumulative effect of accounting changes | | | | 0.03 |
| Diluted income per common share | \$ 0.10 | \$ 0.01 | \$ 0.16 | \$ 0.08 |
| Basic weighted shares outstanding | 21,455 | 21,217 | 21,446 | 21,136 |
| Diluted weighted average common shares outstanding | 56,560 | 53,731 | 56,584 | 57,432 |

See notes to consolidated financial statements.

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VAALCO ENERGY, INC. AND SUBSIDIARIES
STATEMENTS OF CONSOLIDATED CASH FLOWS

(Unaudited)

(in thousands of dollars)

| | Six months Ended June 30, | |
|--|------------------------------|----------------|
| | 2004 | 2003 |
| Operating activities: | | |
| Net income | \$ 9,108 | \$ 4,446 |
| Depreciation, depletion and amortization | 1,693 | 2,973 |
| Non-cash compensation expense | | 276 |
| Amortization of debt discount | | 1,624 |
| Exploration expense | 142 | 122 |
| Cumulative effect of accounting change | | (1,717) |
| Minority interest in earnings of subsidiary | 1,098 | 639 |
| Asset retirement accretion expense | 35 | 44 |
| Gain on sale of assets | (83) | |
| Change in operating assets and liabilities: | | |
| Funds in escrow | (2) | (2) |
| Trade receivables | 51 | 706 |
| Accounts with partners | (5,869) | 734 |
| Other receivables | 204 | 491 |
| Crude oil inventory | (587) | (307) |
| Materials and supplies | 75 | (550) |
| Prepayments and other | (635) | (518) |
| Accounts payable and accrued liabilities | 2,989 | (7,863) |
| Income taxes payable | (45) | 1 |
| Deferred taxes | (145) | |
| Net cash provided by (used in) operating activities | 8,029 | 1,099 |
| Investing activities: | | |
| Discontinued operations transaction expense | (980) | |
| Exploration expense | (142) | (122) |
| Additions to property and equipment | (6,689) | (358) |
| Other | 105 | 133 |
| Net cash used in investing activities | (7,706) | (347) |
| Financing activities: | | |
| Proceeds from the issuance of common stock | 23 | 125 |
| Funds in escrow, net | 997 | 8,906 |
| Debt repayment | (1,750) | (11,000) |
| Distribution to minority interest | (100) | (120) |
| Purchase of treasury shares | | (104) |
| Net cash used in financing activities | (830) | (2,193) |

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| | | |
|---|------------------|-----------------|
| Net change in cash and cash equivalents | (507) | (1,441) |
| Cash and cash equivalents at beginning of period | 22,995 | 7,724 |
| Cash and cash equivalents at end of period | \$ 22,488 | \$ 6,283 |
| Supplemental disclosure of cash flow information: | | |
| Income taxes paid | \$ 3,430 | \$ 2,353 |
| Interest paid | \$ 178 | \$ 909 |

See notes to consolidated financial statements.

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VAALCO ENERGY, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE SIX MONTHS ENDED JUNE 30, 2004
(Unaudited)

1. UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS AND ACCOUNTING POLICIES

The consolidated financial statements of VAALCO Energy, Inc. and subsidiaries (collectively, "VAALCO" or the "Company"), included herein are unaudited, but include all adjustments consisting of normal recurring accruals which the Company deems necessary for a fair presentation of its financial position, results of operations and cash flows for the interim period. Such results are not necessarily indicative of results to be expected for the full year. These financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Form 10-KSB for the year ended December 31, 2003, which also contains a summary of the significant accounting policies followed by the Company in the preparation of its consolidated financial statements. These policies were also followed in preparing the quarterly report included herein. The Company follows the successful efforts method of accounting for exploration expense.

VAALCO Energy, Inc., a Delaware corporation, is a Houston-based independent energy company principally engaged in the acquisition, exploration, development and production of crude oil and natural gas. VAALCO owns producing properties and conducts exploration activities as operator of consortiums internationally in Gabon, West Africa. Domestically, the Company has interests in the Texas Gulf Coast area.

VAALCO's subsidiaries holding interests in Gabon are VAALCO Energy (International), Inc., VAALCO Gabon (Etame), Inc. and VAALCO Production (Gabon), Inc. VAALCO Energy (USA), Inc. holds interests in certain properties in the United States. Other subsidiaries are Alcorn (Philippines) Inc., Alcorn (Production) Philippines Inc. and Altisima Energy, Inc.

2. RECENT DEVELOPMENTS

On April 30, 2004, the Company executed a purchase and sale agreement with its partners in the Philippines to sell all of its interests in Service Contract 6 and Service Contract 14, including the Matinloc and Nido fields. Terms of the sale included the assumption by the partners of the Company's entire share of any abandonment, environmental or other liabilities whatsoever, associated with the Service Contracts. (See Note 6).

3. EARNINGS PER SHARE

The Company accounts for earnings per share in accordance with Statement of Financial Accounting Standards (SFAS) No. 128 "Earnings per Share," which establishes the requirements for presenting earnings per share (EPS). SFAS No. 128 requires the presentation of basic and diluted EPS on the face of the income statement. Basic EPS is calculated using the average number of shares of common stock outstanding during each period. Diluted EPS assumes the conversion of preferred stock to common stock and the exercise of all stock options and warrants having exercise prices less than the average market price of the common stock using the treasury stock method. On June 30, 2004, the Company's preferred stock was convertible into 27.5 million shares of common stock.

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VAALCO ENERGY, INC. AND SUBSIDIARIES
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 FOR THE SIX MONTHS ENDED JUNE 30, 2004
(Unaudited)

Diluted Shares consist of the following:

| Item | Three months ended June 30, 2004 | Six months ended June 30, 2004 |
|--|-------------------------------------|-----------------------------------|
| Basic weighted average common stock issued and outstanding | 21,455,060 | 21,446,406 |
| Preferred stock convertible to common stock | 27,500,000 | 27,500,000 |
| Dilutive warrants | 5,533,993 | 5,559,913 |
| Dilutive options | 2,071,215 | 2,078,419 |
| Total diluted shares | 56,560,268 | 56,584,738 |

4. ASSET RETIREMENT OBLIGATION

In August 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS No. 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible, long-lived assets and the associated asset retirement costs. This statement requires that the fair value of a liability for an asset retirement obligation (ARO) be recognized in the period in which it is incurred by capitalizing it as part of the carrying amount of the long-lived assets. As required by SFAS No. 143, the Company adopted this new accounting standard on January 1, 2003. The statement requires the systematic, accretion and depreciation of future abandonment costs of tangible assets such as platforms, wells, service assets, pipelines, and other facilities. SFAS No. 143 requires that the fair value of a liability for an asset's retirement obligation be recorded in the period in which it is incurred if a reasonable estimate of fair value can be made, and that the corresponding cost is capitalized as part of the carrying amount of the related long-lived asset. The liability is accreted to its then present value each period, and the capitalized cost is depreciated over the useful life of the related asset. If the liability is settled for an amount other than the recorded amount, a gain or loss is recognized. Adoption of SFAS No. 143 resulted in a \$1.7 million gain due to the effect of the accounting change in 2003.

Adopting SFAS No. 143 had no impact on the Company's reported cash flows. During the six months ending June 30, 2004 and 2003, the Company recognized \$35,000 in accretion expense to reflect the fair value of the ARO.

5. RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the FASB issued SFAS No. 141, Business Combinations, which requires the purchase method of accounting for business combinations initiated after June 30, 2001 and eliminates the pooling-of-interests method. In July 2001, the FASB also issued SFAS No. 142, Goodwill and Other Intangible Assets, which discontinues the practice of amortizing goodwill and indefinite lived intangible assets and initiates an annual review for impairment. Intangible assets with a determinable useful life will continue to be amortized over that

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VAALCO ENERGY, INC. AND SUBSIDIARIES
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(Unaudited)

period. The amortization provisions apply to goodwill and intangible assets acquired after June 30, 2001. SFAS Nos. 141 and 142 clarify that more assets should be distinguished and classified between tangible and intangible. The staff of the SEC and the accounting industry are currently in discussion regarding the application of SFAS Nos. 141 and 142 to companies engaged in the oil and gas business. SFAS Nos. 141 and 142 may require oil and gas companies to classify contractual property rights (such as the Company's concessions in Gabon and the Company's leases in the United States) as intangible assets. Fee mineral interests would be classified as tangible assets. Consistent with industry practice, the Company has not classified contractual mineral rights as intangible assets. If it is ultimately determined that SFAS Nos. 141 and 142 require classification of contractual mineral rights as intangible assets, the Company's oil and gas properties would be reduced by \$59,000 and intangible assets would be increased by a like amount at June 30, 2004. The provisions of SFAS No. 141 and 142 impact only the balance sheet and associated footnote disclosures. Reclassifications would not impact the Company's cash flows or results of operations. The Financial Accounting Standards Board (FASB) has issued a proposed FASB Staff Position (FSP 142-b) to address the application of SFAS 142 to the oil and gas industry. If adopted as written, the proposed FSP would confirm our historical treatment of these costs. We will continue to monitor this issue.

In December 2002, FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*. SFAS No. 148 amends SFAS No. 123 *Accounting for Stock Based Compensation* to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. During the first quarter of 2003, an officer of the Company exercised options for 221,000 shares, resulting in a compensation expense of \$276,250, which was recorded as a general and administrative expense. SFAS No. 123, *Accounting for Stock-Based Compensation* encourages, but does not require, companies to record compensation cost for stock-based employee compensation plans at fair value as determined by generally recognized option pricing models such as the Black-Scholes model or the binomial model. Because of the inexact and subjective nature of deriving non-freely traded employee stock option values using these methods, the Company has adopted the disclosure-only provisions of SFAS No. 123 and continues to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*. Accordingly, no compensation cost has been recognized for the Company's stock-based plans. Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the optional method prescribed by SFAS No. 123, the Company's net income and net income per share would have been adjusted to the pro forma amounts indicated below (in thousands, except per share data):

| | Three months ended June 30, | |
|---|--|---------------|
| | 2004 | 2003 |
| Net income as reported | \$ 5,855 | \$ 465 |
| Deduct: Total stock based employee compensation expense | 172 | — |
| Proforma net income | \$ 5,883 | \$ 465 |
| Basic earnings per share | | |
| As reported | \$ 0.27 | \$ 0.02 |

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| | | |
|----------------------------|---------|---------|
| Pro forma | \$ 0.26 | \$ 0.02 |
| Diluted earnings per share | | |
| As reported | \$ 0.10 | \$ 0.01 |
| Pro forma | \$ 0.10 | \$ 0.01 |

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VAALCO ENERGY, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 FOR THE SIX MONTHS ENDED JUNE 30, 2004
(Unaudited)

| | Six months ended June 30, | |
|---|------------------------------|----------|
| | 2004 | 2003 |
| Net income as reported | \$ 9,108 | \$ 4,446 |
| Deduct: Total stock based employee compensation expense | 346 | 78 |
| Proforma net income | \$ 8,762 | \$ 4,368 |
| Basic earnings per share | | |
| As reported | \$ 0.42 | \$ 0.21 |
| Pro forma | \$ 0.41 | \$ 0.21 |
| Diluted earnings per share | | |
| As reported | \$ 0.16 | \$ 0.08 |
| Pro forma | \$ 0.15 | \$ 0.08 |

The total stock based employee compensation expense was determined under the fair value based method for all awards, net of related tax effects.

The effects of applying SFAS No. 123 in the disclosure may not be indicative of future amounts as additional awards in future years are anticipated.

The valuation of the options is based upon a Black-Scholes model assuming expected volatility of 38%, risk-free interest rate of 5.5%, expected life of options of 3 to 5 years, depending upon the award and an expected dividend yield of 0%.

In November 2002, FASB issued Interpretation (FIN) No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, which elaborates on the disclosure to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. As set forth in the interpretation, the disclosures required are designed to improve the transparency of

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VAALCO ENERGY, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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(Unaudited)

the financial statement information about the guarantor's obligations and liquidity risks related to guarantees issued. The fair values of guarantees entered into after December 31, 2002, must be recorded as a liability in the financial statements of the guarantor. Existing guarantees as of December 31, 2002 are grandfathered from the recognition provisions, unless they are later modified, but they are still required to be disclosed.

The Company charters a floating production, storage and offloading system (FPSO) for use in the Etame field, and as operator of the Etame field, guaranteed the charter payments through September 2004. The charter of the FPSO continues beyond September 2004 unless one year's prior notice is given to the owner of the FPSO. The Company obtained several guarantees from its partners for their share of the charter payment. The Company's share of the charter payment is 28.1%. The estimated obligations for the full charter payment and the Company's share of the charter payments are as follows (in thousands of dollars):

| <u>Year</u> | <u>Full Charter Payment</u> | <u>Company Share</u> |
|-------------|-----------------------------|----------------------|
| 2004 | \$ 9,024 | \$ 2,533 |
| 2005 | \$ 9,024 | \$ 2,533 |

6. DISCONTINUED OPERATIONS

On April 30, 2004, the Company closed upon the sale of all of its assets associated with Service Contract 6 and Service Contract 14 in the Philippines. The company has restated earnings to break out the results of discontinued operations for prior periods in its financial statements. The Company realized a gain on the sale of the assets of \$83,000 after paying transaction costs of \$980,000 as follows.

| | <u>(thousands of dollars)</u> |
|---|-------------------------------|
| Future asset retirement obligations assumed by buyer | \$ 1,498 |
| Book value of assets transferred to buyer | |
| Materials and supplies | (321) |
| Prepaid expenses | (2) |
| Notes receivable | 1 |
| Property and equipment | (4) |
| Deposits and other assets | (12) |
| Accounts due partners | (97) |
| Payments required under the Purchase and Sale Agreement | |
| Payment to contingency fund | (198) |
| Payment to operating account | (136) |
| Severance benefits | (610) |
| Other closing costs | (36) |

| | |
|--------------------|----|
| Gain on asset sale | 83 |
|--------------------|----|

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VAALCO ENERGY, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 FOR THE SIX MONTHS ENDED JUNE 30, 2004
(Unaudited)

Income (loss) from discontinued operations**Income (loss) from discontinued operations**

| | <u>Three months ended</u> <u>June 30,</u> | | <u>Six months ended</u> <u>June 30,</u> | |
|--|--|-------------|--|-------------|
| | <u>2004</u> | <u>2003</u> | <u>2004</u> | <u>2003</u> |
| Revenues from oil sales | 40 | 229 | 40 | 421 |
| Operating costs and expenses | | | | |
| Production Expenses | 32 | 140 | 71 | 273 |
| Depreciation, depletion and amortization | | 1 | | 46 |
| General and administrative expenses (reimbursements) | (132) | 80 | 31 | 176 |
| | <u>(100)</u> | <u>222</u> | <u>102</u> | <u>495</u> |
| Total operating costs and expenses | | | | |
| Other revenues (expenses) | | | | |
| Interest income | 1 | 2 | 5 | 5 |
| Other expenses (net) | 5 | (18) | (6) | (11) |
| | <u>146</u> | <u>(8)</u> | <u>(63)</u> | <u>(80)</u> |
| Income (loss) from discontinued operations before income taxes | | | | |
| Income tax expense | | | (3) | |
| | <u>146</u> | <u>(8)</u> | <u>(60)</u> | <u>(80)</u> |
| Income (loss) from discontinued operations net of tax | | | | |

7. SUBSEQUENT EVENT

On July 21, 2004, the Company listed its common stock on the American Stock Exchange. In connection with the listing, the 1818 Fund, II converted 3,333-1/3 of their 10,000 preferred shares into 9,166,666 shares of common stock. The remaining preferred shares still have the right to elect three directors, and vote with the common stock at the rate of 2,750 common share votes per share of preferred stock.

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VAALCO ENERGY, INC. AND SUBSIDIARIES
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This report includes forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (Exchange Act). All statements other than statements of historical fact included in this report (and the exhibits hereto), including without limitation, statements regarding the Company's financial position and estimated quantities and net present values of reserves, and statements preceded by, followed by or that otherwise include the word believe, expects, anticipates, intends, projects, target, goal, objective, should, or similar expressions or variations of such forward looking statements. The Company can give no assurances that the assumptions upon which such statements are based will prove to have been correct. Important factors that could cause actual results to differ materially from the Company's expectations (Cautionary Statements) include volatility of oil and gas prices, future production costs, future production quantities, operating hazards, and statements set forth in the Risk Factors section included in the Company's Forms 10-KSB, which are herein incorporated by reference. All subsequent written and oral forward looking statements attributable to the Company or persons acting on its behalf are expressly qualified by the Cautionary Statements.

INTRODUCTION

The Company's results of operations are dependent upon the difference between prices received for its oil and gas production and the costs to find and produce such oil and gas. Oil and gas prices have been and are expected in the future to be volatile and subject to fluctuations based on a number of factors beyond the control of the Company. The Company does not presently engage in any hedging activities and has no plans to do so.

The Company's primary source of revenue was from the Etame field located offshore the Republic of Gabon. During the first half of 2004, the Etame field produced approximately 2.7 million barrels (0.6 million barrels net to the Company).

The Company operates the Etame field on behalf of a consortium of five companies. The Etame field was developed in 2002 at a total cost approximately \$57.3 million (\$17.4 million net to the Company inclusive of \$1.5 million of the Company share of the Gabon Government carried 7.5% interest). The Etame field produces at approximately 14,500 to 15,000 BOPD.

On May 12, 2004, the Company spudded the Etame-5H well, which is a development well in the Etame field. This is the first of two development wells under the Phase 2 Development Plan for the Etame field which was approved by the Gabon government October 2003. The second development well is expected to be drilled in 2005. From June until July 2004, the Etame-5H well was suspended after successfully encountering pay in the Gamba sand to move to the Avouma prospect. The Company has moved back onto the Etame-5H well and is currently performing completion operations. The budget for adding the Etame-5H development well is \$28.8 million (\$8.7 million net to the Company) and includes laying two new flowlines and umbilicals from the well site to the FPSO. The extra flowline and umbilical are to be laid with the first development well to eliminate the need to mobilize lay vessel equipment when the second development well is drilled in 2005.

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In December 2003, the Company drilled an exploration well and reached total depth in January 2004. The well, the Ebouri No. 1, resulted in a new Gamba sand discovery. Two sidetracks were performed to delineate the discovery, each of which logged a comparable amount of oil pay in the Gamba. The Company is performing economic studies to determine the feasibility of developing the discovery.

In June 2004, the Company drilled a second exploration well, the EAVOM-1 well, on the Avouma prospect. This well tested approximately 6,600 barrels oil per day from 20 feet of perforations in the Gamba sand. The discovery is approximately 10.5 miles southeast of the Etame field and is located adjacent to the South Tchibala discovery made by another operator in 1978. The Company is currently evaluating the cost of a development of both Avouma and South Tchibala to determine the feasibility of developing the discoveries. The estimated cost for the Ebouri and Avouma exploration wells is \$17.2 million (\$5.2 million net to the Company). The Company has used cash on hand and cash flow from operations to fund the exploration and development wells.

The Company's results of operations are affected by currency exchange rates. While oil sales are denominated in U.S. dollars, portions of operating costs in Gabon are denominated in local currencies. An increase in the exchange rate of the local currencies to the dollar will have the effect of increasing operating costs while a decrease in the exchange rate will reduce operating costs. The Gabon local currency is tied to the Euro, which appreciated substantially against the dollar in 2003.

Substantially all of the Company's oil production is located offshore of Gabon. In Gabon, the Company produces into a 1.1 million barrel tanker and sells cargos to Shell Oil at spot market prices.

CAPITAL RESOURCES AND LIQUIDITY

Cash Flows

Net cash provided by operating activities for the six months ended June 30, 2004 was \$8.0 million, as compared to \$1.1 million provided by operations for the six months ended June 30, 2003. Net funds provided by operations in 2004 included net income of \$9.1 million, non-cash depreciation, depletion and amortization of \$1.7 million, minority interest add back of \$1.1 million and working capital decreases of \$4.0 million. In 2003, net cash used by operating activities included net income of \$4.4 million, non-cash depreciation, depletion and amortization of \$3.0 million, non-cash interest expense of \$1.6 million, a reduction for the effect of accounting change of \$1.7 million and add back of minority interest of \$0.6 million. In 2003, working capital decreases totaled \$7.2 million, primarily due to a \$7.8 million reduction in accounts payable.

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Net cash used in investing activities for the six months ended June 30, 2004 was \$7.7 million, as compared to net cash used in investing activities of \$0.3 million for the six months ended June 30, 2003. In 2004, the Company added to its investment in Gabon by participating in the Ebouri and Avouma prospect exploration wells and for the drilling of the ET-5H well. The Ebouri and Avouma wells are classified as work in progress. In 2003, the Company invested \$0.4 million to fund its share of ongoing investments in the Etame Block.

In the six months ended June 30, 2004, net cash used in financing activities was \$0.8 million consisting of \$1.75 million of debt reduction, offset by the release of \$1.0 million of funds in escrow associated with the Ebouri drilling program. Net cash used in financing activities in the six months ended June 30, 2003 was \$2.2 million consisting of \$11.0 million of debt repayment, offset by \$8.9 million of funds released from escrow.

Capital Expenditures

During the six months ended June 30, 2004, the Company spent \$6.6 million (excluding \$3.0 million in accounts payable) on activities associated with the Phase 2 development of Etame-5H and to drill of the Ebouri and Avouma exploration wells. During 2004, the Company anticipates participating in additional exploration and development opportunities on the Etame Block, which will be funded by cash flow from operations. Total Phase 2 development and exploration capital expenditures for 2004 are budgeted to be approximately \$13.8 million net to the Company of which approximately \$7.9 million remains to be spent as of June 30, 2004.

Historically, the Company's primary sources of capital resources has been from cash flows from operations, private sales of equity, borrowings and purchase money debt. At June 30, 2004 the Company had cash of \$22.5 million. The Company believes that this cash combined with cash flow from operations will be sufficient to fund the Company's remaining 2004 capital expenditure budget of approximately \$7.9 million, required debt repayments of \$2.3 million and additional investments in working capital resulting from potential growth. As operator of the Etame field, the Company enters into project related activities on behalf of its working interest partners. The Company generally obtains advances from its partners prior to significant funding commitments.

On April 19, 2002, to fund its share of the Phase 1 Etame field development costs, the Company entered into a \$10.0 million credit facility with the International Finance Corporation (IFC), a subsidiary of the World Bank. To date the Company has repaid \$4.75 million of the loan as called for under the facility repayment schedule.

On September 8, 2002, the Company commenced production from the Etame field offshore Gabon. Through June 30, 2004 total field production sold was 8.9 million barrels (1.8 million barrels net to the Company).

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Substantially all of the Company's crude oil and natural gas is sold at the well head at posted or index prices under short-term contracts. In Gabon, the Company markets its crude oil under an agreement with Shell Western Trading and Supply, Limited. While the loss of Shell Oil as a buyer might have a material adverse effect on the Company in the near term, management believes that the Company would be able to obtain other customers for its crude oil.

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Domestically, the Company produces from wells in Brazos County, Frio County and Dimmit County, Texas. Domestic production is sold via separate contracts for oil and gas. The Company has access to several alternative buyers for oil and gas sales domestically.

Contractual Obligations

The Company has completed the commitments to the Gabon government under the third exploration period of the Etame contract. The Company anticipates entering into the two year fourth exploration period, beginning in October 2004, which requires a gross expenditure for exploration activities of \$5.0 million (\$1.5 million net to the Company).

In addition to its lending relationships and obligations, the Company has contractual obligations under operating leases. The table below summarizes these obligations and commitments at June 30, 2004 (in thousands):

| <u>Payment Period</u> | <u>Remainder of 2004</u> | <u>2005</u> | <u>2006</u> | <u>Thereafter</u> |
|-----------------------|--------------------------|-------------|-------------|-------------------|
| Long Term Debt | 1,500 | 2,250 | 1,250 | 250 |
| Operating Leases | 9,389 ¹ | 9,094 | 144 | 156 |

- The Company is Guarantor of a lease for an FPSO utilized in Gabon, which represents \$9,024,000 of the 2004 and 2005 obligations. The Company can cancel the lease anytime with 12 month prior notice. Approximately 72% of the payment is co-guaranteed by the Company's partners in Gabon.

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RESULTS OF OPERATIONS

Three months ended June 30, 2004 compared to three months ended June 30, 2003

Revenues

Total revenues were \$11.6 million for the three months ended June 30, 2004 compared to \$6.9 million for the comparable period in 2003. The Company sold approximately 339,000 net barrels of oil equivalent at an average price of \$34.23 in 2004. In 2003, the Company sold approximately 254,000 barrels of oil equivalent at an average price of \$27.51 per barrel. The higher oil sales in 2004 are primarily due to timing differences associated with liftings from the Etame field.

Operating Costs and Expenses

Total production expenses for the three months ended June 30, 2004 were \$2.2 million compared to \$1.7 million in the three months ended June 30, 2003. Production expenses in the second quarter of 2004 are higher due to larger volumes of oil sold in 2004.

Exploration expense was \$26,000 for the three months ended June 30, 2004 compared to \$73,000 in the comparable period in 2003. Exploration expense in both periods was for seismic reprocessing and interpretation.

Depreciation, depletion and amortization expenses were \$0.9 million in the three months ended June 30, 2004 compared to \$1.5 million in the three months ended June 30, 2003. The lower depreciation, depletion and amortization expenses in 2004 reflect the effects of the increase in reserves booked to the Etame field at year end 2003. General and administrative expenses for the three months ended June 30, 2004 and 2003 were \$0.2 million for each period, respectively. In 2004 and 2003, the Company benefited from overhead reimbursement associated with production and operations on the Etame block.

Other Income (Expense)

Interest income received on amounts on deposit was \$52,000 in the three months ended June 30, 2004 compared to \$17,000 in the three months ended June 30, 2003. Interest expense and financing charges for the IFC loan were \$0.1 million in the quarter ended June 30, 2004. The

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Company had interest expense of \$1.7 million in the three months ended June 30, 2003 associated with the IFC and 1818 Fund loans. The amount included \$1.6 million of debt discount associated with the warrants issued in conjunction with the 1818 Fund loan, which was repaid ahead of schedule in the second quarter of 2003.

Income Taxes

Income taxes amounted to \$1.9 million and \$1.1 million for the quarters ended June 30, 2004 and 2003 respectively. In both periods, the income tax was paid in Gabon. The higher income tax paid in 2004 was due to higher volumes sold at higher prices. The Company also paid \$55,000 in estimated alternative minimum tax in the quarter ending June 30, 2004, which was recorded as a deferred tax asset.

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Discontinued Operations

Income from discontinued operations in the Philippines in the second quarter of 2004 was \$0.1 million compared to a loss of \$8,000 in the second quarter of 2003. The Company benefited from reimbursement of expenses incurred in the first quarter to normalize for the February 1, 2004 effective date of the transaction, which closed April 30, 2004. The Company also recorded a \$0.1 million gain on the disposal of discontinued operations in the second quarter of 2004.

Minority Interest

The Company incurred \$0.7 million in minority interest charges in the three months ended June 30, 2004. These minority interest charges were associated with the VAALCO Energy (International), Inc. subsidiary that is 90.01% owned by the Company. In the three months ended June 30, 2003, minority interest charges of \$0.2 million were incurred. The Company distributed \$0.1 million of the minority interest accrued charges in each of the three months ended June 30, 2004 and 2003.

Net Income

Net income attributable to common stockholders for the three months ended June 30, 2004 was \$5.9 million, compared to net income attributable to common stockholders of \$0.5 million for the same period in 2003. In 2003, the Company experienced lower crude sales volumes at lower prices, and incurred non-cash interest expense associated with the repayment of the 1818 fund loan of \$1.6 million.

Six months ended June 30, 2004 compared to six months ended June 30, 2003

Revenues

Total revenues were \$19.8 million for the six months ended June 30, 2004 compared to \$15.3 million for the same period in 2003. The increase in revenues was due to higher crude oil sales of approximately 603,000 barrels of oil equivalent in 2004 compared to 523,000 barrels of oil equivalent in 2003. Crude oil prices averaged \$32.74 per barrel of oil equivalent in 2004 compared to \$29.31 in 2003.

Operating Costs and Expenses

Total production expenses for the six months ended June 30, 2004 were \$4.1 million compared to \$3.3 in the six months ended June 30, 2003. Production expenses in 2004 included \$0.3 million of additional costs associated with a domestic payment obligation which the Company did not have in 2003. Production expenses were also higher in 2004 than in 2003 due to the larger volume of oil sold.

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Exploration expense was \$142,000 for the six months ended June 30, 2004 compared to \$122,000 in the comparable period in 2003. The exploration expenditures in both periods were associated with a seismic reprocessing and interpretation efforts in Gabon. Depreciation, depletion and amortization expense were \$1.7 million in the six months ended June 30, 2004 compared to \$3.0 million in the six months ended June 30, 2003. The lower deprecation, depletion and amortization expenses in 2004 reflect the effects of the increase in reserves booked to the Etame field at year end 2003. General and administrative expenses for the six months ended June 30, 2004 and 2003 were \$0.2 million and \$0.9 million, respectively. The Company experienced higher general and administrative reimbursements in 2004 than in 2003 from partners in the Etame concession associated with higher levels of capital expenditures in 2004. General and administrative expenses in 2003 also included \$0.3 million of compensation expense associated with the exercise of stock options by an officer of the Company. The Company did not incur such compensation expense in 2004.

Other Income (Expense)

Interest income of \$0.1 million was received from amounts on deposit during the six months ended June 30, 2004 compared to \$32,000 during the six months ended June 30, 2003. In 2004, the Company incurred \$0.3 million in interest expense associated with the IFC development loan. Interest expense and financing charges for the IFC loan and the 1818 Fund loan amounted to \$2.3 million in the six months ended June 30, 2003. The amount included \$1.6 million of debt discount associated with the warrants issued in conjunction with the 1818 Fund loan, which was repaid ahead of schedule in the second quarter of 2003.

Income Taxes

Income taxes amounted to \$3.3 million and \$2.4 million for the six months ended June 30, 2004 and 2003 respectively. These income taxes were paid in Gabon, and were higher in 2004 due to higher volumes of crude oil sold at higher prices. The Company paid \$150,000 in alternative minimum taxes in the first half of 2004 which was recorded as a deferred tax asset.

Discontinued operations

The company incurred a loss on discontinued operations of \$0.1 million in each of the six months ended June 30, 2004 and 2003. The Company also recorded a \$0.1 million gain on the disposal of discontinued operations in the first half of 2004.

Minority Interest

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The Company incurred \$1.1 million in minority interest charges in the six months ended June 30, 2004 associated with the VAALCO Energy (International), Inc. subsidiary that is 90.01% owned by the Company. \$100,000 of this minority interest charge was distributed to the minority interest owner in the second quarter of 2004. Minority interest charges of \$0.6 million were incurred during the six months ended June 30, 2003.

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VAALCO ENERGY, INC. AND SUBSIDIARIES
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Cumulative effect of accounting change

The Company recognized a gain of \$1.7 million in the six months ended June 30, 2004 from the change in accounting principle associated with the adoption of SFAS No. 143 Accounting for Asset Retirement Obligations.

Net Income (Loss)

Net income attributable to common stockholders for the six months ended June 30, 2004 was \$9.1 million, compared to net income attributable to common stockholders of \$4.4 million for the same period in 2003. The higher net income in 2004 was due to higher crude oil sales at higher prices, lower depletion expense and lower interest costs. Net income in 2003 included a \$1.7 million one-time gain from the change in accounting principle associated with the adoption of SFAS No. 143 on January 1, 2003.

ITEM 3. CONTROLS AND PROCEDURES

The Company's management, including the Company's principal executive officer and principal financial officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based upon that evaluation, the Company's principal executive officer and principal financial officer have concluded that the disclosure controls and procedures were effective as of the end of the period covered by this Quarterly Report on Form 10-Q.

There were no changes in the Company's internal control over financial reporting that occurred during the Company's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

- 3. Articles of Incorporation and Bylaws
- 3.1 Restated Certificate of Incorporation (incorporated by reference to exhibit 4.1 to the Company's Registration Statement on Form S-3 filed with the Commission on July 15, 1998, Reg. No. 333-59095).
- 3.2 Certificate of Amendment to Restated Certificate of Incorporation (incorporated by reference to exhibit 4.2 to the Company's Registration Statement on Form S-3 filed with the Commission on July 15, 1998, Reg. No. 333-59095).
- 3.3 Bylaws (incorporated by reference to exhibit 4.3 to the Company's Registration Statement on Form S-3 filed with the Commission on July 15, 1998, Reg. No. 333-59095).
- 3.4 Amendment to Bylaws (incorporated by reference to exhibit 4.4 to the Company's Registration Statement on Form S-3 filed with the Commission on July 15, 1998, Reg. No. 333-59095).
- 3.5 Designation of Convertible Preferred Stock, Series A (incorporated by reference to exhibit 4.1 to the Company's Report on Form 8-K filed with the Commission on May 6, 1998, File No. 000-20928)

Additional Exhibits

- 31.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act Of 2002.
- 31.2 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act Of 2002.
- 32.1 Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002

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(b) Reports on Form 8-K.

None

SIGNATURES

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

VAALCO ENERGY, INC.

(Registrant)

By /s/ W. RUSSELL SCHEIRMAN

W. Russell Scheirman, President,

Chief Financial Officer and Director

(on behalf of the Registrant and as the

principal financial officer)

Dated: August 13, 2004

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EXHIBIT INDEX

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