

Citadel Exploration, Inc.
Form 10-Q
August 13, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended June 30, 2018

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

Commission file number 000-54639

CITADEL EXPLORATION, INC.

(Exact name of registrant as specified in its charter)

| | |
|--|--------------------------------------|
| Nevada | 27-1550482 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| | |
|--|--------------|
| 417 31st Street, Unit A, Newport Beach, CA | 92663 |
| (Address of principal executive offices) | (Zip Code) |

(949) 612-8040
(Registrant's telephone number, including area code)

Indicate by check mark whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company or an emerging growth company. See definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

The number of shares of Common Stock, \$0.001 par value, outstanding on August 13, 2018 was 45,000,000 shares.

CITADEL EXPLORATION, INC.

QUARTERLY PERIOD ENDED JUNE 30, 2018

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PART I – FINANCIAL INFORMATION**Item 1. Unaudited Consolidated Financial Statements.****CITADEL EXPLORATION, INC.****CONSOLIDATED BALANCE SHEETS**

| | June 30, 2018 (unaudited) | December 31, 2017 |
|---|---------------------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash | \$19,377 | \$772,103 |
| Other receivable | 126,962 | 16,540 |
| Prepaid expenses | 88,161 | 29,280 |
| Product inventory | — | 20,107 |
| Total current assets | 234,500 | 838,030 |
| Deposits | 35,100 | 10,100 |
| Restricted cash | 200,000 | 200,000 |
| Oil and gas properties, net (successful efforts basis) | | |
| Proved | 5,887,316 | 5,018,086 |
| Unproved | 1,170,000 | 1,170,000 |
| Fixed assets, net | 75,147 | 82,969 |
| Total assets | \$7,602,063 | \$7,319,185 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | \$2,175,964 | \$2,220,938 |
| Accrued interest payable | 284,613 | 459,416 |
| Drilling obligation, net of discount of \$84,000 and \$126,000 as of June 30, 2018 and December 31, 2017 respectively | 707,129 | 700,000 |
| Notes payable, net | 1,752,431 | 579,951 |
| Total current liabilities | 4,920,137 | 3,960,305 |
| Asset retirement obligation | 243,284 | 224,380 |
| Related party production payment liability | 300,000 | 300,000 |
| Total liabilities | 5,463,421 | 4,484,685 |
| Stockholders' equity (deficit): | | |
| Common stock, \$0.001 par value, 300,000,000 shares authorized, 45,000,000 and 44,449,742 shares issued and outstanding as of June 30, 2018 and December 31, 2017 | 45,000 | 44,450 |

respectively

| | | |
|---|--------------|--------------|
| Series A Preferred stock, \$20.00 par value, 500,000 shares authorized, 395,615 and 394,365 shares issued and outstanding as of June 30, 2018 and December 31, 2017 | 7,912,300 | 7,887,300 |
| respectively | | |
| Additional paid-in capital | 5,959,407 | 5,691,239 |
| Accumulated deficit | (11,778,065) | (10,788,489) |
| Total stockholders' equity (deficit) | 2,138,642 | 2,834,500 |
| | | |
| Total liabilities and stockholders' equity (deficit) | \$7,602,063 | \$7,319,185 |

See Accompanying Notes to Unaudited Consolidated Financial Statements.

Table of Contents**CITADEL EXPLORATION, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(unaudited)**

| | For the three months ended June 30, | | For the six months ended June 30, | |
|---|---|--------------|---|--------------|
| | 2018 | 2017 | 2018 | 2017 |
| Revenue | \$299,989 | \$49,723 | \$512,542 | \$86,648 |
| Operating expenses: | | | | |
| Lease operating expense | 150,546 | 74,094 | 436,342 | 122,775 |
| General and administrative | 71,513 | 52,907 | 144,639 | 118,189 |
| Depreciation, depletion and amortization | 166,826 | 10,024 | 272,298 | 18,122 |
| Professional fees | 61,642 | 59,969 | 142,286 | 123,117 |
| Executive compensation | 180,000 | 152,295 | 360,000 | 306,885 |
| Total operating expenses | 630,527 | 349,289 | 1,355,565 | 689,088 |
| Loss from operations | (330,538) | (299,566) | (843,023) | (602,440) |
| Other expenses: | | | | |
| Interest expense | (107,123) | (349,235) | (146,553) | (374,567) |
| Total other expenses | (107,123) | (349,235) | (146,553) | (374,567) |
| Loss before provision for income taxes | (437,661) | (648,801) | (989,576) | (977,007) |
| Income tax benefit | — | — | — | (112) |
| Net Loss | \$(437,661) | \$(648,801) | \$(989,576) | \$(976,895) |
| Series A preferred stock dividends | (197,266) | — | (392,055) | — |
| Net loss attributable to common stockholders | \$(634,927) | \$(648,801) | \$(1,381,631) | \$(976,895) |
| Weighted average number of common shares - outstanding - basic and diluted | 45,000,000 | 40,336,620 | 44,863,194 | 40,336,620 |
| Net loss per share – basic and diluted | \$(0.01) | \$(0.02) | \$(0.03) | \$(0.02) |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

Table of Contents**CITADEL EXPLORATION, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited)**

| | For the six months Ended June 30, | |
|--|---|--------------|
| | 2018 | 2017 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net loss | \$(989,576) | \$(976,895) |
| Depreciation, depletion and accretion | 272,298 | 18,122 |
| Amortization of debt discount | 88,622 | — |
| Preferred stock dividend expense | — | 406,800 |
| Stock based compensation expense | 90,051 | — |
| Changes in operating assets and liabilities: | | |
| Decrease (increase) in other receivable | (110,422) | (10,315) |
| Decrease (increase) in prepaid expenses | 10,814 | (40,398) |
| Increase (decrease) in deposits | (25,000) | — |
| Increase (decrease) in accrued interest payable | 54,585 | (33,170) |
| Increase (decrease) in accounts payable and accrued payables | 75,026 | 218,644 |
| Net cash used in operating activities | (533,602) | (417,212) |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Exploration and development of oil and gas properties | (1,219,186) | (229,129) |
| Cash received from disposal of O&G asset | 131,240 | — |
| Purchase of equipment | (6,749) | (2,215) |
| Net cash used in investing activities | (1,094,695) | (231,344) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Proceeds from sale of preferred stock, net of costs | 25,000 | 475,000 |
| Proceeds from notes payable | 920,612 | 67,552 |
| Repayments to drilling liability | (34,871) | — |
| Repayments of notes payable | (35,170) | (46,994) |
| Net cash provided by financing activities | 875,571 | 495,558 |
| Net increase in cash, cash equivalents, and restricted cash | (752,726) | (152,998) |
| Cash and restricted cash at beginning of year | 972,103 | 433,793 |
| Cash and restricted cash at end of the period | \$219,377 | \$280,795 |
| Supplemental disclosures of cash flow information: | | |
| Reclass of inventory to O&G properties | 20,107 | — |
| Income taxes paid (credit) | — | (112) |
| Non-cash investing and financing activities: | | |
| Insurance premium financing | 69,695 | — |
| Shares issued to pay off bonus payable | 20,000 | — |
| Debt Discount from senior secured credit facility | 158,667 | — |
| Asset retirement obligation | 12,128 | — |
| Non-cash addition of senior loan facility for payment of San Benito litigation | 100,000 | — |

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| | | |
|--|---------|-------------|
| Accrued interest payable rolled over to senior loan facility | 229,388 | — |
| Conversion from preferred stock issuable | — | \$6,514,600 |
| Issuance for preferred stock for services | — | \$92,708 |
| Issuance of common stock for preferred stock interest | — | \$406,800 |

See Accompanying Notes to Unaudited Consolidated Financial Statements.

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CITADEL EXPLORATION, INC.

Notes to Unaudited Consolidated Financial Statements

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation

The accompanying unaudited interim financial statements and notes for the Company have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading.

These statements reflect all adjustments, consisting of normal recurring adjustments, which in the opinion of management, are necessary for fair presentation of the information contained therein. It is suggested that these interim consolidated financial statements be read in conjunction with the financial statements of the Company for the period ended June 30, 2018 and notes thereto included in the Company's 10-K annual report and all amendments. The Company follows the same accounting policies in the preparation of interim reports.

Results of operations for the interim period are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2018.

Principles of consolidation

The consolidated financial statements include the accounts of Citadel Exploration, Inc., Citadel Exploration, LLC and Citadel Kern Bluff, LLC, the Company's wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated. Citadel Exploration, Inc., Citadel Exploration, LLC and Citadel Kern Bluff, LLC will be collectively referred herein to as the "Company".

Nature of operations

Currently, the Company is focused on the acquisition and development of oil and gas properties in California.

Impairment

The Company evaluates the impairment of its proved oil and natural gas properties on a field-by-field basis whenever events or changes in circumstances indicate that the carrying value may not be recoverable. The carrying values of proved properties are reduced to fair value when the expected undiscounted future cash flows are less than net book value. The fair values of proved properties are measured using valuation techniques consistent with the income approach, converting future cash flows to a single discounted amount. Significant inputs used to determine the fair values of proved properties include estimates of: (i) reserves; (ii) future operating and development costs; (iii) future commodity prices; and (iv) a market-based weighted average cost of capital rate. As of June 30, 2018, management believes that no impairment indicators exist.

Use of estimates

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ significantly from those estimates. The accounting policies most affected by management's estimates and assumptions are the following. The reliance on estimates of proved reserves to compute the provision for depreciation, depletion and amortization and to determine the amount of any impairment of proved properties. The valuation of unproved acreage and proved crude oil and natural gas properties to determine the amount of any impairment of crude oil and natural gas properties. Judgement regarding the productive status of in-progress exploratory wells to determine the amount of any provision for abandonment and estimates regarding abandonment liabilities.

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CITADEL EXPLORATION, INC.

Notes to Unaudited Consolidated Financial Statements

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Fair value of financial instruments

The carrying value of the Company's financial instruments, including cash, due to shareholders/related parties and accounts and other payables approximate their fair values due to the immediate or short-term maturity of these instruments. It is management's opinion that the Company is not exposed to significant interest, price or credit risks arising from these financial instruments.

Reclassification and comparative figures

Certain reclassifications have been made to conform the prior period's financial information to the current period's presentation. These reclassifications had no effect on previously reported net loss or accumulated deficit.

Cash and cash equivalents

The Company considers all highly liquid instruments with maturity of three months or less at the time of issuance to be cash equivalents. The Company had no cash equivalents as of June 30, 2018 and December 31, 2017.

Earnings per share

The Company follows ASC Topic 260 to account for the earnings per share. Basic earnings per common share ("EPS") calculations are determined by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per common share calculations are determined by dividing net income by the weighted average number of common shares and dilutive common share equivalents outstanding. During periods when common stock equivalents, if any, are anti-dilutive they are not considered in the computation.

Disaggregation of revenue

The Company does not disaggregate revenue, as all revenue is generated from oil at one property located in California. Revenues for the three months ending June 30, 2018 and 2017 was \$299,989 and \$49,723. Revenues for the six months ending June 30, 2018 and 2017 was \$512,542 and \$86,648.

Recent accounting pronouncements

In May 2014, the FASB issued ASC updated No. 2014-09, *Revenue from Contracts with Customers (Topic 606 (ASU 2014-09))*. Under the amendments in this update, recognition of revenue occurs when a customer obtains control of promised goods or services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, the new standard requires that reporting companies disclose the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The amendments in this update are effective for fiscal years and interim periods within those years beginning after December 15, 2017 and supersedes any previous revenue recognition guidance. Implementation of Topic 606 was done using the modified retrospective approach. Adoption of this new standard did not have an impact on the Company's balance sheet, statement of operations, statement of stockholders' equity or statement of cash flows.

In November 2016, the FASB issued ASU 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash" ("ASU 2016-18"). The update is effective for years beginning December 15, 2017, including interim reporting periods within those fiscal years. Early adoption is permitted. The purpose of Update 216-18 is to clarify guidance and presentation related to restricted cash in the Statements of Cash Flows. The amendment requires beginning-of-period and end-of-period total amounts shown on the Statements of Cash Flows to include cash and cash equivalents as well as restricted cash and restricted cash equivalents. Adoption of this new standard did not have a material impact on the Company's financial statements.

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The accompanying unaudited consolidated financial statements have been prepared assuming that the Company will continue as a going concern, which contemplates the recoverability of assets and the satisfaction of liabilities in the normal course of business. In addition, the Company's development activities since inception have been financially sustained through debt and equity financing. There can be no assurance that the Company will be successful to raise sufficient cash to operate over the 12 months immediately following the issuance of its financial reports. The Company incurred a net loss in the amount of \$989,576 for the period ended June 30, 2018. The Company has incurred net losses since entering the crude oil and natural gas exploration industry and as of June 30, 2018 has an accumulated deficit of \$11,778,065 and a working capital deficit of \$4,685,637 which raises substantial doubt about the Company's ability to continue as a going concern.

The ability of the Company to continue as a going concern is dependent upon its ability to raise additional capital from the sale of common stock and, ultimately, the achievement of significant operating revenues. These consolidated financial statements as of June 30, 2018, do not include any adjustments relating to the recoverability and classification of recorded asset amounts or amounts and classification of liabilities that might result from this uncertainty.

NOTE 3 – OIL AND GAS PROPERTIES

Oil and natural gas properties, buildings and equipment consist of the following:

| | June 30, 2018 (unaudited) | December 31, 2017 |
|--|---------------------------------|----------------------|
| Oil and Natural Gas: | | |
| Proved properties | \$3,973,449 | \$3,468,306 |
| Unproved properties | 1,170,000 | 1,170,000 |
| Facilities | 2,297,724 | 2,244,716 |
| | 7,441,173 | 6,883,022 |
| Less oil property impairment | — | (562,030) |
| Less accumulated depreciation, depletion, and amortization | (383,858) | (132,906) |
| | 7,057,315 | \$6,188,086 |

Total accumulated depreciation totaled \$383,858 and \$132,906, respectively, as of June 30, 2018 and December 31, 2017. For the period ending June 30, 2018 and June 30, 2017 total depletion expense totaled \$250,951 and \$8,242, respectively.

NOTE 4 – RESTRICTED CASH

Restricted cash consists of one bond totaling \$200,000, which is a blanket bond that will cover up to 50 wells. This bond was required in the normal course of business in the oil and gas industry. The bond totaling \$200,000 was purchased in August 2015 following the acquisition of the Kern Bluff Oil Field.

NOTE 5 – DEPOSITS

The Company had deposits at June 30, 2018 and December 31, 2017 totaling \$35,100 and \$10,100, respectively. For the period ended June 30, 2018, the Company incurred a \$25,000 deposit for natural gas purchases.

Table of Contents**CITADEL EXPLORATION, INC.****Notes to Unaudited Consolidated Financial Statements****NOTE 6 – NOTES PAYABLE**

Notes payable consists of the following:

| | June 30, 2018 (unaudited) | December 31, 2017 |
|--|---------------------------------|----------------------|
| Note payable to an entity for the financing of insurance premiums, unsecured 7.99% interest, due February 2019 | \$55,779 | \$14,548 |
| Debt Discount on Senior Secured Facility Loan | \$(112,044) | — |
| Senior Secured Facility Loan 10% interest; due March 31, 2019. | 1,750,000 | — |
| Chandler/Lloyd Trust-Notes Payable | — | 500,000 |
| Note payable to an entity for the financing of a company vehicle, secured; 4.95% interest, due October 2022 | 29,759 | 32,351 |
| Note payable to an entity for the financing of a company vehicle, secured; 4.95% interest, due November 2022 | 28,937 | 33,052 |
| Total – Notes Payable | \$1,752,431 | \$579,951 |

In March of 2018, the Company closed on a \$3,000,000 senior secured credit facility. The facility bears 10% interest and has a one-year term. For every two dollars drawn on the facility, the investor receives one five-year warrant to purchase common stock at a price of \$0.10. The Company has drawn down \$1,750,000 on the facility and issued 875,000 warrants. The warrants were valued using the relative fair value and the amount recorded as a debt discount amortized over the life of the line of credit using effective interest method. Future drawdowns are at the discretion of the lender. The senior secured facility is secured by a deed of trust on the Kern Bluff Oil Field. Proceeds from the first draw were used to retire the previous bridge loan and accrued interest. The balance was used for general corporate purposes, including the drilling of a well.

NOTE 7 – STOCKHOLDERS' EQUITY (DEFICIT)

The Company is authorized to issue 300,000,000 shares of its \$0.001 par value common stock. The Company is authorized to issue 500,000 shares of Series A Convertible Participating Preferred Stock.

For the six-months ended June 30, 2018, the Company issued 450,262 and 100,000 common shares for \$90,051 of services rendered and \$20,000 of bonus payable, respectively. For the three and six month ended March 31, 2018 and June 30, 2018 the common stock balances were the same. The Company also issued 1,250 preferred shares for \$25,000 cash. For the six-months ended June 30, 2018, the Company incurred a net loss of \$989,576. For the three

and six month ended March 31, 2018 and June 30, 2018 the preferred stock balances were the same.

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The following is a summary of the status of all of the Company's stock options as of June 30, 2018 and changes during the period ended on that date:

| | Number of Options | Weighted-Average Exercise Price | Weighted-Average Remaining Life (Years) |
|-------------------------------------|----------------------|------------------------------------|---|
| Outstanding as of December 31, 2017 | 9,500,000 | \$ 0.20 | 3.26 |
| Granted | — | \$ 0.00 | — |
| Exercised | — | \$ 0.00 | — |
| Cancelled | — | \$ 0.00 | — |
| Outstanding as of June 30, 2018 | 9,500,000 | \$ 0.20 | 2.76 |
| Exercisable at June 30, 2018 | 9,500,000 | \$ 0.20 | 2.76 |

NOTE 9 – WARRANTS

In March 2018, the Company closed on a \$3,000,000 Senior Secured Credit Facility. The Company drew down \$1,750,000 at close. As per the terms of the facility, the Company issued 875,000 warrants to the lender. The warrants were valued using the relative fair value and the amount recorded as a debt discount amortized over the life of the line of credit using effective interest method

| | Number of Warrants | Weighted-Average Exercise Price | Weighted-Average Remaining Life (Years) |
|------------------------------------|--------------------------|------------------------------------|---|
| Outstanding at December 31, 2017 | | \$0.00 | — |
| Granted | 875,000 | \$0.10 | 5.00 |
| Exercised | — | \$0.00 | — |
| Cancelled | — | \$0.00 | — |
| Total Outstanding at June 30, 2018 | 875,000 | \$0.10 | 4.71 |
| Exercisable at June 30, 2018 | 875,000 | \$0.10 | 4.71 |

NOTE 10 – RELATED PARTY TRANSACTIONS

During the six months ended June 30, 2018, the Company purchased \$120,717 of equipment from Grey Energy. Grey Energy is owned by a member of the Board of Directors of the Company. As of the end of the period, the Company had a production payment liability of \$300,000 outstanding to a related party. The CEO & CFO continue to defer \$20,000 a month of their \$30,000 per month salary. For the six-month period ended June 30, 2018, the CEO & CFO deferred \$240,000 in salary.

NOTE 11 – DRILLING OBLIGATION

The Company entered into a joint venture agreement with investors to drill two wells in the fourth quarter of 2017. The \$700,000 liability has an 18% rate of return. The Company originally booked a debt discount of \$126,000 and will be amortized over the next 18 months. During the six-month ended, the company amortized \$42,000 of the debt discount. During the period, the Company paid \$34,871 towards this obligation from oil production.

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FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements and involves risks and uncertainties that could materially affect expected results of operations, liquidity, cash flows, and business prospects. These statements include, among other things, statements regarding:

o exploration risks such as drilling unsuccessful wells;

o our ability to operate profitably;

o our ability to efficiently and effectively finance our operations;

o inability to achieve future sales levels or other operating results;

o inability to raise additional financing for working capital;

o inability to efficiently manage our operations;

o inability to hire or retain sufficient qualified operating field personnel;

o the inability of management to effectively implement our strategies and business plans;

o the unavailability of funds for capital expenditures and/or general working capital;

o deterioration in general or regional economic conditions;

o the fact that our accounting policies and methods are fundamental to how we report our financial condition and results of operations, and they may require management to make estimates about matters that are inherently uncertain;

o changes in U.S. GAAP or in the legal, regulatory and legislative environments in the markets in which we operate;

o

adverse state or federal legislation or regulation that increases the costs of compliance, or adverse findings by a regulator with respect to existing operations;

As well as other statements regarding our future operations, financial condition and prospects, and business strategies. These forward-looking statements are subject to certain risks and uncertainties that could cause our actual results to differ materially from those reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this Quarterly Report on Form 10-Q, and in particular, the risks discussed under the heading “Risk Factors” in Part II, Item 1A and those discussed in other documents we file with the Securities and Exchange Commission. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

References in the following discussion and throughout this quarterly report to “we”, “our”, “us”, “Citadel”, “the Company”, and similar terms refer to Citadel Exploration, Inc. and its subsidiary, unless otherwise expressly stated or the context otherwise requires.

AVAILABLE INFORMATION

We file annual, quarterly and other reports and other information with the SEC. You can read these SEC filings and reports over the Internet at the SEC's website at www.sec.gov or on our website at www.citadelexploration.com. You can also obtain copies of the documents at prescribed rates by writing to the Public Reference Section of the SEC at 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 am and 3:00 pm. Please call the SEC at (800) SEC-0330 for further information on the operations of the public reference facilities. We will provide a copy of our annual report to security holders, including audited financial statements, at no charge upon receipt to of a written request to us at Citadel Exploration, Inc., 417 31st Street, Unit A, Newport Beach, California 92663.

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

Overview

Citadel is an energy company engaged in the exploration and development of oil and natural gas properties. Our properties are located in the San Joaquin Basin of California. Subject to availability of capital, we strive to implement an accelerated development program utilizing capital resources, a regional operating focus, an experienced management and technical team, and enhanced recovery technologies to attempt to increase production and increase returns for our stockholders. Our corporate strategy is to build value in the Company through the acquisition of oil and gas leases with significant upside potential, successful exploration and exploitation and the efficient development of these assets.

Our revenues, profitability and future growth depend substantially on prevailing prices for oil and natural gas and our ability to find, develop and acquire oil and gas reserves that are economically recoverable.

Our Operations

Our principal strategy is to focus on the acquisition of oil and natural gas mineral leases that have known hydrocarbons or are in close proximity to known hydrocarbons that have been underdeveloped. Once acquired, we strive to implement an accelerated development program utilizing capital resources, a regional operating focus, an experienced management and technical team, and enhanced recovery technologies to attempt to increase production and increase returns for our stockholders. Our oil and natural gas acquisition and development activities are currently focused in the State of California.

On July 31, 2015 Citadel acquired approximately 1,100 acres of leases, production facilities and equipment that encompassed the Kern Bluff Oil Field. As consideration for this acquisition Citadel issued 6,000,000 shares of common stock and paid \$2,000,000 in cash. The transaction was financed via a \$3,500,000 one-year term loan from Cibolo Creek Partners, of Midland Texas. In March of 2016, Cibolo Creek Partners converted the \$3,500,000 term loan into Series A Convertible Participating Preferred Stock.

In December of 2015, Citadel shifted its CAPEX focus to remediation of the existing acquired facilities. At the time of purchase, the oil at Kern Bluff was being processed by temporary facilities installed by the previous owner. As production increased in September, it quickly became apparent that these facilities were not capable of processing the additional volumes of oil and water being produced. The existing permanent facilities were built in the 1970's by Gulf Oil and require extensive remediation including new pipe, valves, flanges and tank repair.

In July of 2016, Citadel completed its facility upgrades the new facilities have production capacity of 500 BOPD. Citadel drilled three wells in June of 2016 and returned to production 9 idle wells.

In December of 2017, Citadel completed the installation of a 25MM BTU steam generator. The oil and Kern Bluff is characterized as heavy oil, therefore requiring stimulation via steam injection. This steam generator has capacity of over 1,400 barrels of steam per day (BOSPD) which will allow the Company to steam approximately 50 wells per year.

In February of 2018, Citadel completed the drilling of three new wells. The company currently has approximately 14 wells on production and has seen field wide production increase from approximately 20 barrels per day to approximately 100 barrels per day.

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In July of 2018, Citadel announced it had produced 3,000 barrels of oil in the month of June, equating to 100 barrels per day average. The Company plans to accelerate development in the fourth quarter 2018 with the drilling of a horizontal well at Kern Bluff.

Going Concern

The consolidated financial statements included in this filing have been prepared in conformity with generally accepted accounting principles that contemplate the continuance of the Company as a going concern, which contemplates the realization of assets and liquidation of liabilities in the normal course of business. As shown on the accompanying consolidated financial statements, the Company has incurred an accumulated deficit in the amount of \$11,778,065 as of June 30, 2018. These conditions raise substantial doubt about the Company's ability to continue as a going concern.

The future of the Company is dependent upon its ability to obtain financing and upon future profitable operations from the development of its oil and gas business opportunities.

RESULTS OF OPERATIONS

Results of Operations for the Three Months Ended June 30, 2018 and June 30, 2017 and the Six Months Ended June 30, 2018 and June 30, 2017

During the three-month period ended June 30, 2018 and June 30, 2017 the Company generated \$299,989 and \$49,723, respectively, from the sale of oil. During the six-month period ended June 30, 2018 and June 30, 2017 the Company generated \$512,542 and \$86,648, respectively, from the sale of oil.

Operating expenses totaled \$630,527 during the three-month period ended June 30, 2018 which was an increase over the period ended June 30, 2017 of \$349,289. For the six-month period ended June 30, 2018, operating expenses totaled \$1,355,565 which was an increase over the period six-month ended June 30, 2017 of \$689,088. Operating expenses consisted of lease operating expense, general and administrative costs, depletion, depreciation, and amortization, professional fees, and executive compensation. The increase consisted primarily of an increase in lease operating expenses and depreciation and depletion.

General and administrative fees increased from \$52,907 to \$71,513 from the three-month period ended June 30, 2017 to the three-month period ended June 30, 2018. For the six-month period ended June 30, 2017 to the six-month period

ended June 30, 2018, general and administrative fees increased from \$118,189 to \$144,639. The increase was primarily due to insurance, marketing and meals and entertainment expenses.

Professional fees increased from \$59,969 to \$61,642 from the three-month period ended June 30, 2017 to the three-month period ended June 30, 2018. For the six-month period ended June 30, 2017 to the six-month period ended June 30, 2018 professional fees increased from \$123,117 to \$142,286. The increase was primarily due to services provided to the Company for accounting, consulting and legal.

Executive compensation increased from \$152,295 to \$180,000 from the three-month period ended June 30, 2017 to the three-month period ended June 30, 2018. For the six-month period ended June 30, 2017 to the six-month period ended June 30, 2018 executive compensation increased from \$306,885 to \$360,000. The increase was due to the salary increase based upon the employment agreement.

Table of Contents**Liquidity and Capital Resources**

The Company has established a capital budget for 2018 of \$6,000,000 to return to production up to 10 wells and drill up to 20 vertical wells and 1 horizontal well. The Company's ability to complete this capital budget will be highly dependent on higher oil prices and access to capital.

As of June 30, 2018, the Company had \$234,500 of current assets; of this amount \$19,377 was cash and \$200,000 was restricted cash. The following table provides detailed information about the net cash flow for the quarters ended June 30, 2018 and June 30, 2017 as presented in this quarterly report. To date, we have financed our operations through the issuance of stock and borrowings from related parties and an unrelated third party.

The following table sets forth a summary of our cash flows for the six months ended June 30, 2018 and 2017:

| | Six Months Ended | |
|--|-------------------------|-------------|
| | June 30, | |
| | 2018 | 2017 |
| Net cash used in operating activities | \$(533,602) | \$(417,212) |
| Net cash used in investing activities | (1,094,695) | (231,344) |
| Net cash provided by financing activities | 875,571 | 495,558 |
| Net change in cash, cash equivalents and restricted cash | (752,726) | (152,998) |
| Cash and restricted cash, beginning of period | 972,103 | 433,793 |
| Cash and restricted cash, end of period | \$219,377 | \$280,795 |

Operating activities

The net loss in the period was greater than the non-cash adjustments to reconcile the changes in the balance sheet and statement of operations, which is the reason cash used in operating activities was negative.

Investing activities

For the six-month period ended June 30, 2018 and June 30, 2017, the net cash used in investing activities consisted of drilling expenses and facility upgrades on oil and gas properties totaling \$1,219,186 and \$231,334 respectively.

Financing activities

As of June 30, 2018, we continue to use traditional and/or debt financing as well as through the issuance of stock to provide the capital we need to run our business.

Without cash flow from operations we will require additional cash resources, including the sale of equity or debt securities, to meet our planned capital expenditures and working capital requirements for the next 12 months. We will require additional cash resources due to changed business conditions, implementation of our strategy to successfully develop our Kern Bluff Oil Field, and or acquisitions we may decide to pursue. If our own financial resources and then current cash-flows from operations are insufficient to satisfy our capital requirements, we may seek to sell additional equity or debt securities or obtain a credit facility. The sale of additional equity securities will result in dilution to our stockholders. The incurrence of indebtedness will result in increased debt service obligations and could require us to agree to operating and financial covenants that could restrict our operations or modify our plans to grow the business. Financing may not be available in amounts or on terms acceptable to us, if at all. Any failure by us to raise additional funds on terms favorable to us, or at all, will limit our ability to expand our business operations and could harm our overall business prospects.

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Our ability to obtain additional capital through additional equity and/or debt financing, and Joint Venture or Working Interest partnerships will also be important to our expansion plans. In the event we experience any significant problems assimilating acquired assets into our operations or cannot obtain the necessary capital to pursue our strategic plan, we may have to reduce the growth of our operations. This may materially impact our ability to increase revenue and develop our assets.

Contractual Obligations

An operating lease for rental office space was entered into beginning March 1, 2013 for two years at \$2,150 per month. The original lease was amended to include additional space at a price of \$1,100 per month for the same term. The original term of the lease expired on March 1, 2015. As such our office lease is now on a month to month basis at a rate of \$3,000 per month.

Off-Balance Sheet Arrangements

As of the date of this report, we did not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

Operation Plan

Our plan is to focus on the acquisition and drilling of prospective oil and natural gas mineral leases. Once we have tested a prospect as productive, subject to availability of capital, we will implement a development program with a regional operating focus in order to increase production and increase returns for our stockholders. Exploration, acquisition and development activities are currently focused in California. Depending on availability of capital, and other constraints, our goal is to increase stockholder value by finding and developing oil and natural gas reserves at costs that provide an attractive rate of return on our investments.

We expect to achieve these results by:

- Investing capital in exploration and development drilling and in secondary and tertiary recovery of oil as well as natural gas;

•Using the latest technologies available to the oil and natural gas industry in our operations;

•Finding additional oil and natural gas reserves on the properties we acquire.

In addition to raising additional capital we plan to take on Joint Venture (JV) or Working Interest (WI) partners who may contribute to the capital costs of drilling and completion and then share in revenues derived from production. This economic strategy may allow us to utilize our own financial assets toward the growth of our leased acreage holdings, pursue the acquisition of strategic oil and gas producing properties or companies and generally expand our existing operations.

Our future financial results will depend primarily on: (i) the ability to continue to source and screen potential projects; (ii) the ability to discover commercial quantities of natural gas and oil; (iii) the market price for oil and natural gas; and (iv) the ability to fully implement our exploration and development program, which is dependent on the availability of capital resources. There can be no assurance that we will be successful in any of these respects, that the prices of oil and gas prevailing at the time of production will be at a level allowing for profitable production, or that we will be able to obtain additional funding to increase our currently limited capital resources.

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Item 3. Quantitative and Qualitative Disclosure About Market Risk

This item is not applicable as we are currently considered a smaller reporting company.

Item 4T. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer, Armen Nahabedian, and our Chief Financial Officer, Philip McPherson evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of the end of the period covered by this Report. Based on that evaluation and assessment, Mr. Armen Nahabedian and Mr. Philip McPherson concluded that our disclosure controls and procedures are not designed at a reasonable assurance level and are not effective to provide reasonable assurance that information we are required to disclose in the reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our principal executive and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitations on Effectiveness of Controls and Procedures

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

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PART II—OTHER INFORMATION

Item 1. Legal Proceedings.

From time to time, we may become involved in various lawsuits and legal proceedings which arise in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these or other matters may arise from time to time that may harm our business. At this time, we are not engaged in any legal proceedings where by a court of law will assess any monetary damages against the Company.

Item 1A. Risk Factors.

Our significant business risks are described in Item 1A. to Part I of Form 10-K for the year ended December 31, 2017 (filed April 16, 2018) to which reference is made herein.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Stock Issuances pursuant to Subscription Agreements

In March of 2017, the Company filed the appropriate paperwork with the State of Nevada, authorizing the issuance of up to 500,000 shares of Series A Preferred Stock, 500,000 shares of Series B Preferred Stock and 500,000 shares of Series C Preferred Stock. The company also increased the authorized amount of common shares from 100,000,000 to 300,000,000. As of June 30, 2018, we have issued 395,615 of Series A Preferred Shares, and zero shares of Series B or C.

We believe that the issuance and sale of the above securities were exempt from the registration and prospectus delivery requirements of the Securities Act of 1933 by virtue of Section 4(2), Regulation D and/or Regulation S. The securities were issued directly by us and did not involve a public offering or general solicitation. The recipient of the securities was afforded an opportunity for effective access to files and records of our company that contained the relevant information needed to make her investment decision, including our financial statements and 34 Act reports. We reasonably believed that the recipient, immediately prior to issuing the securities, had such knowledge and experience in our financial and business matters that she was capable of evaluating the merits and risks of its investment. The recipient had the opportunity to speak with our management on several occasions prior to her investment decision. There were no commissions paid on the issuance and sale of the shares.

Option Grants

Our option grants are described in Form 10-K for the year ended December 31, 2017 (filed April 16, 2018) to which reference is made herein.

Subsequent Stock Issuances

None.

Issuer Purchases of Equity Securities

We did not repurchase any of our equity securities from the time of our inception on November 6, 2006 through the period ended June 30, 2018.

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Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

2012 Stock Incentive Plan

On September 1, 2012, we adopted the 2012 Stock Incentive Plan. We have reserved for issuance an aggregate of 10,000,000 shares of common stock under our 2012 Stock Incentive Plan. To date 9,500,000 options and no shares of common stock have been granted under this plan.

Our employment agreements with executive officers are described in Form 10-K for the year ended December 31, 2017 (filed April 1, 2018) to which reference is made herein.

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Item 6. Exhibits.

| Exhibit No. | Description |
|--------------------|--|
| 10.4 | <u>2012 Stock Incentive Plan</u> |
| 31.1 | <u>Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u> |
| 31.2 | <u>Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u> |
| 32.1 | <u>Certifications of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u> |
| 32.2 | <u>Certifications of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u> |
| 101.INS* | XBRL Instance Document |
| 101.SCH* | XBRL Taxonomy Extension Schema |
| 101.CAL* | XBRL Taxonomy Extension Calculation Linkbase |
| 101.DEF* | XBRL Taxonomy Extension Definition Linkbase |
| 101.LAB* | XBRL Taxonomy Extension Label Linkbase |
| 101.PRE* | XBRL Taxonomy Extension Presentation Linkbase |

* *XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.*

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SIGNATURE

Pursuant to 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.

CITADEL EXPLORATION, INC.

Date: August 13, 2018

By: /S/ Armen Nahabedian
Armen Nahabedian
Chief Executive Officer
(Principal Executive Officer and duly authorized
signatory)