

CIMAREX ENERGY CO  
Form 10-Q  
August 03, 2006

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

- Quarterly Report Pursuant To Section 13 or 15(d) of the Securities Exchange Act of 1934**
- Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the Quarterly Period ended June 30, 2006**

**Commission File No. 001-31446**

## **CIMAREX ENERGY CO.**

**1700 Lincoln Street, Suite 1800**

**Denver, Colorado 80203-4518**

**(303) 295-3995**

**Incorporated in the  
State of Delaware**

**Employer Identification  
No. 45-0466694**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No .

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act). (Check One)

Large accelerated filer  Accelerated Filer  Non-accelerated filer

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 Cimarex Energy Co. common stock outstanding as of June 30, 2006 was 82,714,939.



**CIMAREX ENERGY CO.**

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*In this report, we use terms to discuss oil and gas producing activities as defined in Rule 4-10(a) of Regulation S-X. We express quantities of natural gas in terms of thousand cubic feet (Mcf), million cubic feet (MMcf) or billion cubic feet (Bcf). Oil is quantified in terms of barrels (Bbls), thousands of barrels (MBbls) and millions of barrels (MMBbls). Oil is compared to natural gas in terms of equivalent thousand cubic feet (Mcfe) or equivalent million cubic feet (MMcfe). One barrel of oil is the energy equivalent of six Mcf of natural gas. Information relating to our working interest in wells or acreage, net oil and gas wells or acreage is determined by multiplying gross wells or acreage by our working interest therein. Unless otherwise specified, all references to wells and acres are gross.*

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## PART I

## ITEM 1 - Financial Statements

## CIMAREX ENERGY CO.

## Consolidated Balance Sheets

(Unaudited)

|  | June 30,<br>2006                  | December 31,<br>2005 |
|--|-----------------------------------|----------------------|
|  | (In thousands, except share data) |                      |
| <b>Assets</b>  |                                   |                      |
| Current assets:  |                                   |                      |
| Cash and cash equivalents  | \$ 5,389                          | \$ 61,647            |
| Receivables, net   | 251,005                           | 289,184              |
| Inventories  | 43,754                            | 34,784               |
| Deferred income taxes  | 11,105                            | 17,959               |
| Other current assets   | 16,996                            | 25,454               |
| Total current assets   | 328,249                           | 429,028              |
| Oil and gas properties at cost, using the full cost method of accounting:  |                                   |                      |
| Proved properties  | 4,043,220                         | 3,602,797            |
| Unproved properties and properties under development, not being amortized  | 518,154                           | 388,839              |
|  | 4,561,374                         | 3,991,636            |
| Less accumulated depreciation, depletion and amortization  | (1,292,031)                       | (1,114,677)          |
| Net oil and gas properties   | 3,269,343                         | 2,876,959            |
| Fixed assets, net  | 89,419                            | 86,916               |
| Goodwill   | 691,432                           | 717,391              |
| Other assets, net  | 76,839                            | 70,041               |
|  | \$ 4,455,282                      | \$ 4,180,335         |
| <b>Liabilities and Stockholders Equity</b>   |                                   |                      |
| Current liabilities:   |                                   |                      |
| Accounts payable   | \$ 52,897                         | \$ 81,947            |
| Accrued liabilities  | 178,830                           | 179,076              |
| Derivative fair value  | 11,470                            | 41,926               |
| Revenue payable  | 97,931                            | 94,469               |
| Total current liabilities  | 341,128                           | 397,418              |
| Long-term debt   | 403,560                           | 352,451              |
| Deferred income taxes  | 800,047                           | 717,790              |
| Other liabilities  | 118,027                           | 117,223              |
| Stockholders equity:   |                                   |                      |
| Preferred stock, \$0.01 par value, 15,000,000 shares authorized, no shares issued                                    |                                   |                      |
| Common stock, \$0.01 par value, 200,000,000 shares authorized, 83,793,761 and 83,524,285 shares issued, respectively | 838                               | 835                  |
| Treasury stock, at cost, 1,078,822 and 1,146,822 shares held, respectively   | (40,628)                          | (43,554)             |
| Paid-in capital  | 1,860,820                         | 1,865,597            |
| Unearned compensation  |                                   | (15,862)             |
| Retained earnings  | 971,376                           | 788,356              |

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|  |              |              |
|--|--------------|--------------|
| Accumulated other comprehensive income | 114          | 81           |
|  | 2,792,520    | 2,595,453    |
|  | \$ 4,455,282 | \$ 4,180,335 |

See accompanying notes to consolidated financial statements.

## CIMAREX ENERGY CO.

## Consolidated Statements of Operation

(Unaudited)

|   | For the Three Months<br>Ended June 30, |            | For the Six Months<br>Ended June 30, |            |
|---|--|------------|--------------------------------------|------------|
|   | 2006                                   | 2005       | 2006                                 | 2005       |
|   | (In thousands, except per share data)  |            |                                      |            |
| <b>Revenues:</b>  |  |            |                                      |            |
| Gas sales   | \$ 191,658                             | \$ 137,159 | \$ 425,381                           | \$ 243,033 |
| Oil sales   | 108,838                                | 47,862     | 197,110                              | 79,370     |
| Gas gathering and processing  | 12,092                                 | 2,697      | 23,394                               | 2,703      |
| Gas marketing, net of related costs of \$29,784, \$62,178,<br>\$86,962 and \$115,352 respectively | 793                                    | 340        | 2,746                                | 896        |
|   | 313,381                                | 188,058    | 648,631                              | 326,002    |
| <b>Costs and expenses:</b>  |  |            |                                      |            |
| Depreciation, depletion and amortization  | 94,773                                 | 51,582     | 185,401                              | 89,667     |
| Asset retirement obligation accretion   | 1,493                                  | 550        | 2,941                                | 935        |
| Production  | 43,804                                 | 17,412     | 85,576                               | 27,583     |
| Transportation  | 5,483                                  | 3,608      | 9,791                                | 6,082      |
| Gas gathering and processing  | 6,386                                  | 1,809      | 12,939                               | 1,862      |
| Taxes other than income   | 21,934                                 | 13,600     | 45,480                               | 24,495     |
| General and administrative  | 9,990                                  | 7,657      | 20,875                               | 15,549     |
| Stock compensation, net   | 2,096                                  | 1,213      | 4,064                                | 2,438      |
| Expenses related to merger  | (92)                                   | 6,685      | (61)                                 | 6,685      |
| (Gain) loss on derivative instruments   | (3,249)                                | 2,030      | (18,816)                             | 2,030      |
|   | 182,618                                | 106,146    | 348,190                              | 177,326    |
| Operating income  | 130,763                                | 81,912     | 300,441                              | 148,676    |
| <b>Other income and expense:</b>  |  |            |                                      |            |
| Interest expense  | 7,397                                  | 3,771      | 13,887                               | 3,959      |
| Amortization of fair value of debt  | (946)                                  | (416)      | (1,891)                              | (416)      |
| Capitalized interest  | (5,610)                                | (1,179)    | (11,829)                             | (1,179)    |
| Other, net  | (2,036)                                | (2,915)    | (5,378)                              | (4,156)    |
| Income before income tax expense  | 131,958                                | 82,651     | 305,652                              | 150,468    |
| Income tax expense  | 49,092                                 | 30,174     | 112,635                              | 54,626     |
| Net income  | \$ 82,866                              | \$ 52,477  | \$ 193,017                           | \$ 95,842  |
| <b>Earnings per share:</b>  |  |            |                                      |            |
| Basic   | \$ 1.01                                | \$ 1.01    | \$ 2.35                              | \$ 2.04    |
| Diluted   | \$ 0.98                                | \$ 0.98    | \$ 2.27                              | \$ 1.98    |
| <b>Weighted average shares outstanding:</b>   |  |            |                                      |            |
| Basic   | 82,046                                 | 51,967     | 82,067                               | 46,886     |
| Diluted   | 84,861                                 | 53,655     | 84,886                               | 48,427     |

See accompanying notes to consolidated financial statements.



## CIMAREX ENERGY CO.

## Condensed Consolidated Statements of Cash Flows

(Unaudited)

|   | For the Six Months<br>Ended June 30, |           |
|---|--------------------------------------|-----------|
|   | 2006                                 | 2005      |
|   | (In thousands)                       |           |
| Cash flows from operating activities:   |                                      |           |
| Net income  | \$ 193,017                           | \$ 95,842 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                      |           |
| Depreciation, depletion and amortization  | 185,401                              | 89,667    |
| Asset retirement obligation accretion   | 2,941                                | 935       |
| Deferred income taxes   | 108,317                              | 36,119    |
| Stock compensation, net   | 4,064                                | 2,438     |
| Derivative instruments  | (30,456)                             | 1,411     |
| Other   | (306)                                | 6,946     |
| Changes in operating assets and liabilities                                       |                                      |           |
| Decrease in receivables, net  | 55,045                               | 17,341    |
| (Increase) in other current assets  | (10,724)                             | (11,962)  |
| (Decrease) in accounts payable and accrued liabilities                            | (45,945)                             | (39,132)  |
| Increase (decrease) in other non-current liabilities                              | 430                                  | (399)     |
| Net cash provided by operating activities   | 461,784                              | 199,206   |
| Cash flows from investing activities:   |                                      |           |
| Oil and gas expenditures  | (541,787)                            | (204,428) |
| Acquisition of proved oil and gas properties                                      | (4,741)                              | (1,948)   |
| Merger costs  | (439)                                | (11,134)  |
| Cash received in connection with acquisition                                      |                                      | 33,407    |
| Proceeds from sale of assets  | 5,600                                | 405       |
| Other expenditures  | (14,644)                             | (17,362)  |
| Net cash used by investing activities   | (556,011)                            | (201,060) |
| Cash flows from financing activities:   |                                      |           |
| Borrowing (payments) on long-term debt, net                                       | 53,000                               | (60,064)  |
| Treasury Stock acquired   | (11,016)                             |           |
| Dividends paid  | (6,661)                              |           |
| Proceeds from issuance of common stock and other                                  | 2,646                                | 3,477     |
| Net cash (used in) provided by financing activities                               | 37,969                               | (56,587)  |
| Net change in cash and cash equivalents   | (56,258)                             | (58,441)  |
| Cash and cash equivalents at beginning of period                                  | 61,647                               | 115,746   |
| Cash and cash equivalents at end of period  | \$ 5,389                             | \$ 57,305 |

See accompanying notes to consolidated financial statements.



**CIMAREX ENERGY CO.**

Notes to Consolidated Financial Statements

June 30, 2006

(Unaudited)

**1. Basis of Presentation**

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The accompanying financial statements are unaudited and were prepared from the records of Cimarex Energy Co. (Cimarex or the Company). We believe these financial statements include all adjustments necessary for a fair presentation of our financial position and results of operations. We prepared these statements on a basis consistent with the annual audited statements and Regulation S-X. Regulation S-X allows us to omit some of the footnote and policy disclosures required by accounting principles generally accepted in the United States of America and normally included in annual reports on Form 10-K. These interim financial statements should be read in conjunction with the financial statements and notes in our Annual Report on Form 10-K for the year ended December 31, 2005.

In June 2005, Cimarex acquired Magnum Hunter Resources, Inc, by issuing 0.415 shares of Cimarex common stock for each share of outstanding Magnum Hunter common stock, resulting in the issuance of 39.7 million Cimarex common shares. At June 30, 2006, Cimarex had 82.7 million shares outstanding. The merger was accounted for as a purchase of Magnum Hunter by Cimarex. The results of operations of Magnum Hunter were included in our consolidated statements of operations beginning June 7, 2005.

The accounts of Cimarex and its subsidiaries are presented in the accompanying consolidated financial statements. All intercompany accounts and transactions were eliminated in consolidation.

We make certain estimates and assumptions to prepare our financial statements in conformity with accounting principles generally accepted in the United States of America. Those estimates and assumptions affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses during the reporting period and in disclosures of commitments and contingencies. We analyze our estimates, including those related to oil and gas revenues, reserves and properties, as well as goodwill and contingencies, and base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

The more significant areas requiring the use of management's estimates and judgments relate to the estimation of proved oil and gas reserves, the use of these oil and gas reserves in calculating depletion, depreciation and amortization, the use of the estimates of future net revenues in computing ceiling test limitations and estimates of future abandonment obligations used in recording asset retirement obligations. Estimates and judgments are also required in determining reserves for bad debt, impairments of undeveloped properties, the purchase price allocation, assessment of goodwill and valuation of deferred tax assets.

Certain amounts in prior years' financial statements have been reclassified to conform to the 2006 financial statement presentation. Most notably, the presentation of gas marketing and sales activities as discussed below under *Revenue Recognition*.

### *Segment Information*

Cimarex has one reportable segment (exploration and production).

*Revenue Recognition*

Revenues from oil and gas sales are recognized based on the sales method, with revenue recognized on actual volumes sold to purchasers. There is a ready market for oil and gas, with sales occurring soon after production. We market and sell natural gas for working interest partners under short term sales and supply agreements and earn a fee for such services. Revenues are recognized as gas is delivered and are reflected net of gas purchases on the accompanying consolidated statement of operations.

## 2. Business Combination

On June 7, 2005, Cimarex completed the acquisition of Magnum Hunter Resources, Inc, an independent oil and gas exploration and production company with operations concentrated in the Permian Basin of West Texas and New Mexico and in the Gulf of Mexico. Terms of the merger agreement provided that Magnum Hunter stockholders receive 0.415 shares of Cimarex common stock for each share of Magnum Hunter common stock. As a result of the merger, Cimarex issued 39.7 million common shares to Magnum Hunter's common stockholders (excluding 2.5 million shares held in treasury). The results of operations of Magnum Hunter are included in our consolidated statements of operations for the period since the acquisition on June 7, 2005.

The allocation of the purchase price to oil and gas properties utilized prevailing oil and gas prices at the time of negotiations and announcement of the merger. The overall allocation of the purchase price has been finalized and the goodwill amount related to the purchase as of June 30, 2006 equals \$646.4 million.

The following unaudited pro forma information has been prepared to give effect to the Magnum Hunter acquisition as if it had occurred at the beginning of the periods presented. The unaudited pro forma data is presented for illustrative purposes only, based on estimates and assumptions deemed appropriate by management, and should not be relied upon as an indication of the operating results that Cimarex would have achieved if the transaction had occurred on January 1, 2005. The pro forma information also should not be used as an indication of future results or trends.

| (Thousands of dollars, except per share data) | Three Months Ended<br>June 30,<br>2005 | Six Months Ended<br>June 30,<br>2005 |
|---|--|--------------------------------------|
| <b>Pro Forma Statement of Operations Data</b> |  |                                      |
| Revenues                                      | \$ 315,116                             | 601,095                              |
| Net income                                    | 122,793(1)                             | 171,442                              |
| Net income per share:                         |  |                                      |
| Basic   | \$ 1.50                                | 2.10                                 |
| Diluted                                       | 1.48                                   | 2.07                                 |

(1) Includes \$19.2 million of income from Magnum Hunter derivative instruments.

## 3. Derivatives

SFAS No.133, *Accounting for Derivative Instruments and Hedging activities*, requires that all derivatives be recorded on the balance sheet at fair value. We generally determine the fair value of derivative contracts based on the stated contract prices and current and projected market prices at the determination date discounted to

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reflect the time value of money until settlement. Realized and unrealized gains and losses on derivatives that are not designated as hedges are recorded as an expense. In connection with the Magnum Hunter merger, Cimarex recognized a \$39.3 million liability associated with Magnum Hunter's existing commodity derivatives at the merger date (June 7, 2005). These derivative instruments have not been designated for hedge accounting treatment. As a result, Cimarex recognized net gains for the quarter and six months ended June 30, 2006 of \$3.2 million and \$18.8 million, respectively. During the second quarter of 2005 we recorded a net loss of \$2.0 million. Activity includes both non-cash mark-to-market derivative gains and losses as well as cash settlements. Cash payments related to these contracts that settled in the quarter and six months ended June 30, 2006 totaled \$4.1 million and \$11.5 million, respectively. The derivative liability at June 30, 2006 equals \$11.5 million. Cimarex will continue to recognize gains and losses as the remaining derivative instruments expire through December 31, 2006. Actual gains and losses to be recognized may differ materially from the current fair value of amounts recorded. The following is a summary of the company's open derivative contracts as of June 30, 2006:

| Commodity   | Type   | Volume/Day   | Duration |        | Nymex                     |    | Fair Value<br>(000 s) |
|-------------|--------|--------------|----------|--------|---------------------------|----|-----------------------|
|             |        |              |          |        | Weighted Average<br>Price |    |                       |
| Natural Gas | Collar | 20,000 MMBTU | July 06  | Dec 06 | \$5.25 - \$6.30           | \$ | (4,293)               |
| Crude Oil   | Collar | 1,000 BBL    | July 06  | Dec 06 | \$30.00 - \$35.85         |    | (7,178)               |
|             |        |              |          |        |                           | \$ | (11,471)              |

All of the \$11.5 million of derivative liabilities is classified as current on our consolidated balance sheet at June 30, 2006. Weighted average NYMEX prices at June 30, 2006 for the remaining six months of 2006 approximate \$7.15 per Mcf of gas and \$75.40 per barrel of oil.

In July 2006, we entered into additional derivative contracts. These derivatives have been designated for hedge accounting treatment as cash flow hedges. Changes in fair value, to the extent the hedge is effective, will be recognized in other comprehensive income until the hedged item is settled and recognized in earnings. Hedge effectiveness is assessed at least quarterly based on total changes in the derivative's fair value. Any ineffective portion of the derivative instrument's change in fair value is recognized immediately in earnings. The table below sets forth the weighted average terms of the related derivative contracts through August 1, 2006.

| Commodity   | Type    | Volume/Day   | Duration |        | Mid-Continent             |  |
|-------------|---------|--------------|----------|--------|---------------------------|--|
|             |         |              |          |        | Weighted Average<br>Price |  |
| Natural Gas | Collars | 70,000 MMBTU | Jan 07   | Dec 07 | \$7.00 - \$10.05          |  |
| Natural Gas | Collars | 40,000 MMBTU | Jan 08   | Dec 08 | \$7.00 - \$9.90           |  |

#### 4. Stock Plans

**Stock Options**

Cimarex's 2002 Stock Incentive Plan reserves 12.7 million shares of common stock for issuance to directors and employees, including officers. Options granted under the plan after December 5, 2002, expire ten years.



from the grant date and vest in one-fifth increments on each of the first five anniversaries of the grant date. All grants are made at the average of the high and low prices of our common stock as reported on the New York Stock Exchange on the date of grant.

Upon the exercise of the options for shares of common stock, the employee is required to hold at least 50 percent of the profit shares, as defined in the plan, until the eighth anniversary of the grant date. The incentive plan provides for accelerated vesting if there is a change in control (as defined in the plan).

For periods prior to January 1, 2005, we applied Accounting Principles Board (APB) Opinion 25, *Accounting for Stock Issued to Employees*, and related interpretations to account for all stock option grants. No compensation cost had been recognized for stock options granted, as the option prices were equal to the market price of the underlying common stock on the date of grant.

Effective January 1, 2005, we adopted the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123R, *Share Based Payment* on a prospective basis. SFAS No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation to employees. For the quarters ended June 30, 2006 and 2005, compensation expense related to stock options was approximately \$0.5 million and \$0.7 million or \$0.3 million and \$0.4 million after tax, respectively. For the six months ended June 30, 2006 and 2005, compensation expense related to stock options was approximately \$0.9 million and \$1.4 million or \$0.6 million and \$0.8 million after tax (\$.01 and \$.02 per diluted share), respectively.

As discussed more fully in the notes to the financial statements of our annual report on form 10-K for the year ended December 31, 2005, the merger with Magnum Hunter constituted a change of control event under the incentive plan. As a result, all participants became entitled to acceleration of vesting of their options. Cimarex obtained waivers of the accelerated vesting from certain option holders including the company's CEO and other senior officers. Option holders who were not requested to or did not choose to execute a waiver became fully vested in their options on June 7, 2005. Compensation expense related to the accelerated vesting of options was approximately \$1.1 million or \$0.7 million after tax.

The fair value of each option award was estimated as of the date of grant using the Black-Scholes option-pricing model. Expected volatilities were based on the historical volatility of our common stock. The risk free interest rate is based on U.S. Treasury Securities at a constant five year fixed maturity in effect at the date of the grant. Historical data was also used to estimate the probability of option exercise, expected years until exercise and employee termination within the valuation model.

There were no stock options granted to employees during the six months ended June 30, 2006 and 2005.

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The following summary reflects the status of stock options granted to employees and directors as of June 30, 2006, and changes during the period:

|                                   | Shares    | Weighted Average Exercise Price | Weighted Average Remaining Term | Aggregate Intrinsic Value (\$000) |
|-----------------------------------|-----------|---------------------------------|---------------------------------|-----------------------------------|
| Outstanding as of January 1, 2006 | 2,023,388 | \$ 15.64                        |                                 |                                   |
| Exercised                         | (103,310) | 15.60                           |                                 |                                   |
| Granted                           |           |                                 |                                 |                                   |
| Canceled                          |           |                                 |                                 |                                   |
| Outstanding as of June 30, 2006   | 1,920,078 | \$ 15.64                        | 5.0 Years                       | \$ 49,818                         |
| Exercisable as of June 30, 2006   | 1,463,818 | \$ 14.73                        | 4.5 Years                       | \$ 39,264                         |

The total intrinsic value of options exercised during the three months ended June 30, 2006 and 2005 was \$0.1 million and \$3.4 million, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2006 and 2005 was \$3.0 million and \$4.1 million, respectively.

The following summary reflects the status of non-vested stock options granted to employees and directors as of June 30, 2006 and changes during the period:

|                                  | Shares  | Weighted Average Grant Date Fair Value |
|----------------------------------|---------|--|
| Non-vested as of January 1, 2006 | 456,260 | \$ 8.75                                |
| Vested                           |         |  |
| Granted                          |         |  |
| Forfeited                        |         |  |
| Non-vested as of June 30, 2006   | 456,260 | \$ 8.75                                |

As of June 30, 2006 there was \$3.1 million of total unrecognized compensation cost related to non-vested stock options granted under our incentive plan. That cost is expected to be recognized pro rata over a weighted-average period of 2.4 years. The weighted average exercise price of the non-vested stock options was \$18.59. Generally, options vest on the anniversary of the grant date.

Cash received from option exercises during the six months ended June 30, 2006 and 2005 was approximately \$1.6 million and \$4.1 million, respectively. The tax benefit realized for the tax deductions from option exercises totaled approximately \$1.1 million and \$2.9 million, for the six months ended June 30, 2006 and 2005, respectively, and was recorded in paid-in capital.

*Restricted Stock and Units*

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We have a long-term incentive program whereby grants of restricted stock and/or units are awarded to certain employees. The restrictions related to these awards are associated with the continued employment of the grantee for one to five years from the date of the original grant, at which time these shares will vest.

Awards of restricted stock units vest from one to five years from the date of grant and are payable in shares of stock on the eighth anniversary of the date of grant. In accordance with SFAS No 123R, deferred compensation of \$13.9 million and the related unearned compensation were reclassified to paid-in capital. There were 696,641 restricted stock units outstanding as of June 30, 2006.

Awards of restricted stock vest from three to five years from the date of grant and are payable in shares of unrestricted stock on vesting. In accordance with SFAS No 123R, unearned compensation attributable to restricted stock was reclassified to paid-in-capital. At June 30, 2006 there were 663,607 shares of restricted stock outstanding.

The restricted stock and stock unit agreements provide that the grantees will be entitled to receive dividends, when and if declared.

The following summary reflects the status of restricted stock and units granted to employees and directors as of June 30, 2006, and changes during the year:

|                                   | Stock    | Units   |
|-----------------------------------|----------|---------|
| Outstanding as of January 1, 2006 | 249,905  | 697,937 |
| Vested                            | (7,637)  |         |
| Granted                           | 437,639  | 4,954   |
| Canceled                          | (16,300) | (6,250) |
| Outstanding as of June 30, 2006   | 663,607  | 696,641 |

Compensation expense for restricted shares or units is based upon the market price of the restricted grant multiplied by the number of shares of restricted stock or units granted. Compensation cost is being recognized over the associated vesting period. For the six months ended June 30, 2006 and 2005, we recorded compensation expense of \$3.1 million and \$3.6 million, respectively. We also capitalized to oil and gas properties associated costs of \$1.4 million and \$0.6 million, respectively. At June 30, 2006, there was \$29.6 million of unrecognized compensation cost related to grants of restricted stock and units.

### *Declared Dividends and Stock Repurchases*

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In December 2005, the Board of Directors declared the Company's first quarterly dividend of \$.04 per share payable on March 1, 2006 to shareholders of record as of February 15, 2006. In March 2006, a second quarterly dividend of \$.04 per share was declared, payable on June 1, 2006 to shareholders of record as of May 15, 2006. In May 2006 a third quarterly dividend of \$.04 per share was declared, payable on September 1, 2006 to shareholders of record as of August 15, 2006.

In December 2005, the Board of Directors authorized the repurchase of up to four million shares of common stock. Through December 31, 2005, 68,000 shares had been repurchased at an average price of \$43.03. Since December 31, 2005 and through June 2006, an additional 182,100 shares have been repurchased for an average price of \$44.43 per share.

**5. Asset Retirement Obligations**

On January 1, 2003, we adopted SFAS No. 143, *Accounting for Asset Retirement Obligations*. This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The Statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made, and that the associated asset retirement costs be capitalized as part of the carrying amount of the long-lived asset. Oil and gas producing companies incur this liability which includes costs related to the plugging of wells, the removal of facilities and equipment, and site restorations, upon acquiring or drilling a successful well.

The following table reflects the components of the change in the carrying amount of the asset retirement obligation for the six months ended June 30, 2006 (in thousands):

|  |    |         |
|--|----|---------|
| Balance as of January 1, 2006              | \$ | 101,128 |
| Liabilities incurred in the current period |    | 10,115  |
| Liabilities settled in the current period  |    | (593)   |
| Accretion expense                          |    | 2,942   |
| Balance as of June 30, 2006                |    | 113,592 |
| Less: Current asset retirement obligation  |    | (4,319) |
| Long-term asset retirement obligation      | \$ | 109,273 |

**6. Long-Term Debt**





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Prior to the Magnum Hunter merger, Cimarex had no debt. Debt at December 31, 2005 consisted of the following (in thousands):

|   |    |            |
|---|----|------------|
| Bank debt   | \$ |            |
| 9.6% Notes due 2012 (face value \$195,000)                      |    | 213,770(1) |
| Floating rate convertible notes due 2023 (face value \$125,000) |    | 138,681(2) |
| Total long-term debt  | \$ | 352,451    |

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Debt at June 30, 2006 consisted of the following (in thousands):

|   |    |            |
|---|----|------------|
| Bank debt   | \$ | 53,000     |
| 9.6% Notes due 2012 (face value \$195,000)  |    | 212,258(1) |
| Floating rate convertible notes due 2023, 5.33% at June 30, 2006 (face value \$125,000) |    | 138,302(2) |
| Total long-term debt  | \$ | 403,560    |

(1) Fair market value at June 7, 2005 (date of acquisition of Magnum Hunter) equaled \$215.5 million. The subsequent noted balances represent the fair market value at date of acquisition less amortization of the premium of fair market value over face value.

(2) Fair market value at June 7, 2005 equaled \$144.75 million. The subsequent noted balances represent the fair market value at date of acquisition less amortization of the premium of fair market value over face value. Paid-in-Capital was credited with \$49.6 million related to the fair value of common stock associated with the convertible debt at date of acquisition.

Cimarex's Revolving Credit Facility provides for \$500 million of long-term committed credit. The facility is scheduled to mature on July 1, 2010 and is secured by mortgages on certain oil and gas properties and the stock of certain wholly-owned operating subsidiaries. At June 30, 2006, there were outstanding borrowings of \$53 million under the Revolving Credit Facility at a weighted average interest rate of approximately 6.43%. We also had letters of credit for approximately \$2.7 million posted against the borrowing base, leaving an unused borrowing amount of approximately \$444.3 million at June 30, 2006.

The Credit Facility agreement contains both financial and non-financial covenants. Cimarex continues to comply with these covenants and does not view them as materially restrictive.

The 9.6% notes assumed in the Magnum Hunter merger have a face value of \$195 million and are due March 15, 2012. The notes are unsecured and are redeemable, as a whole or in part, at Cimarex's option, on and after March 15, 2007 at the following redemption prices (expressed as percentages of the principal amount), plus accrued interest, if any, thereon to the date of redemption.

| Year                | Percentage |
|---------------------|------------|
| 2007                | 104.8%     |
| 2008                | 103.2%     |
| 2009                | 101.6%     |
| 2010 and thereafter | 100.0%     |

The floating rate convertible senior notes were assumed in the Magnum Hunter merger and mature on December 15, 2023. The notes are senior unsecured obligations and bear interest at an annual rate equal to three-month LIBOR, reset quarterly. On June 30, 2006, the interest rate equaled 5.33%.

Holders of the convertible notes may surrender their notes for conversion into a combination of cash and shares of our common stock upon the occurrence of certain circumstances, including if the price of our

common stock has been trading above the fixed conversion price of \$28.99 per share. On June 30, 2006, the closing price of our common stock traded on the New York Stock Exchange was \$43.00. There is not an observable market for the notes. Based on an average common stock price of \$43.00, management estimates the fair value of the notes at June 30, 2006 was approximately \$185.4 million (or \$1,480 per bond).

In addition to the holders' right to redeem the notes if our common stock price is above the conversion price, the holders also have the right to require Cimarex to repurchase all or a portion of the notes at a repurchase price equal to 100% of the principal amount (plus accrued interest) on December 15, 2008, 2013 and 2018. The indenture agreement also provides Cimarex with an option to redeem some or all of the notes at a redemption price equal to 100% of the principal amount (plus accrued interest) anytime after December 22, 2008.

All long-term debt is guaranteed by Cimarex and all of its subsidiaries, except Canvasback. Assets held by Canvasback consist primarily of 790 thousand shares of Cimarex stock, which is included in Cimarex's Treasury stock.

Total borrowings at June 30, 2006 on the construction loan of Magnum Hunter's 40% owned affiliate, Apple Tree Holdings, LLC ( Apple Tree ) were \$20.6 million, of which our share was \$8.2 million. We have provided a guarantee to the lender for this Construction Loan. In return for our guarantee, we received an up-front fee as well as the right to receive 55% of distributable cash flows from Apple Tree until certain financial tests are met. In the event that the Construction Loan goes into default and we have to perform under the guarantee, we will have recourse against the project and related subsidiaries.

## **7. Income Taxes**

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Federal income tax expense for the periods ended June 30, 2006 and 2005 differ from the amounts that would be provided by applying the U.S. Federal income tax rate due to the effect of state income taxes and other deductible costs.

The components of our provision for income taxes are as follows (in thousands):

|                         | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|-------------------------|--------------------------------|-----------|------------------------------|-----------|
|                         | 2006                           | 2005      | 2006                         | 2005      |
| Current taxes (benefit) | \$ (12,544)                    | \$ 11,367 | \$ 4,318                     | \$ 18,507 |
| Deferred taxes          | 61,636                         | 18,807    | 108,317                      | 36,119    |
|                         | \$ 49,092                      | \$ 30,174 | \$ 112,635                   | \$ 54,626 |

**8.** Supplemental Disclosure of Cash Flow Information (in thousands):

|  | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|--|--------------------------------|-----------|------------------------------|-----------|
|  | 2006                           | 2005      | 2006                         | 2005      |
| Cash paid during the period for:       |                                |           |                              |           |
| Interest                               | \$ 2,597                       | \$ 2,691  | \$ 14,117                    | \$ 2,871  |
| Capitalized interest                   | 5,610                          | 1,179     | 11,829                       | 1,179     |
| Income taxes (net of refunds received) | \$ 15,670                      | \$ 11,112 | \$ 36,085                    | \$ 13,102 |

**9. Earnings per Share**

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The calculations of basic and diluted net earnings per common share are presented below (in thousands, except per share data):

|   | Three Months Ended<br>June 30,        |           | Six Months Ended<br>June 30, |           |
|---|---------------------------------------|-----------|------------------------------|-----------|
|   | 2006                                  | 2005      | 2006                         | 2006      |
|   | (in thousands, except per share data) |           |                              |           |
| Net Income available to common stockholders for basic diluted shares  | \$ 82,866                             | \$ 52,477 | \$ 193,017                   | \$ 95,842 |
| Basic weighted-average shares outstanding   | 82,046                                | 51,967    | 82,067                       | 46,886    |
| Incremental shares from assumed exercise of stock options, vesting of restricted stock units and conversion of convertible senior notes | 2,815                                 | 1,688     | 2,819                        | 1,541     |
| Diluted weighted-average shares outstanding   | 84,861                                | 53,655    | 84,886                       | 48,427    |
| Earnings per share:   |                                       |           |                              |           |
| Basic   | \$ 1.01                               | \$ 1.01   | \$ 2.35                      | \$ 2.04   |
| Diluted   | \$ 0.98                               | \$ 0.98   | \$ 2.27                      | \$ 1.98   |

There were stock options outstanding for 1,920,078 and 2,353,403 shares of Cimarex common stock at June 30, 2006 and 2005, respectively. All stock options and restricted units and shares were considered potentially dilutive securities for each of the periods presented.

**10. Commitments and Contingencies**



*Litigation*

A liability for \$6.5 million for estimated future litigation settlements was recorded in the third quarter of 2005. The proposed settlement will be reviewed by the court for approval.

Cimarex has various litigation related matters in the normal course of business, none of which are material individually or in aggregate.

*Other*

At June 30, 2006, we had firm sales contracts to deliver approximately 2.8 Bcf of natural gas over the next four months. If this gas is not delivered, our financial commitment would be approximately \$14.9 million. This commitment will fluctuate due to price volatility and actual volumes delivered. However, we believe no financial commitment will be due based on our reserves and current production levels.

Cimarex has other various delivery commitments in the normal course of business, none of which are individually material. In aggregate these commitments have a maximum amount that would be payable, if no gas is delivered, of approximately \$3.6 million.

The Company has contractual commitments on oil and gas wells approved for drilling or in the process of being drilled at June 30, 2006 of approximately \$69.5 million.

All of the noted commitments were routine and were made in the normal course of our business.

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

*Throughout this Form 10-Q, we make statements that may be deemed forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities and Exchange Act of 1934. These forward-looking statements include, among others, statements concerning Cimarex's outlook with regard to timing and amount of future production of oil and gas, price realizations, amounts, nature and timing of capital expenditures for exploration and development, plans for funding operations and capital expenditures, drilling of wells, operating costs and other expenses, marketing of oil and gas and other statements of expectations, beliefs, future plans and strategies, anticipated events or trends, and similar expressions concerning matters that are not historical facts. The forward-looking statements in this report are subject to risks and uncertainties that could cause actual results to differ materially from those expressed in or implied by the statements.*

*These risks and uncertainties include, but are not limited to, fluctuations in the price we receive for our oil and gas production, reductions in the quantity of oil and gas sold due to decreased industry-wide demand and/or curtailments in production from specific properties due to mechanical, marketing or other problems, operating and capital expenditures that are either significantly higher or lower than anticipated because the actual cost of identified projects varied from original estimates and/or from the number of exploration and development opportunities being greater or fewer than currently anticipated, and increased financing costs due to a significant increase in interest rates. In addition, exploration and development opportunities pursued by Cimarex may not result in productive oil and gas properties. There are also numerous uncertainties inherent in estimating quantities of proved reserves, projecting future rates of production and the timing of development expenditures. These and other risks and uncertainties affecting Cimarex are discussed in greater detail in this report and in other filings by Cimarex with the Securities and Exchange Commission.*

### INTRODUCTION

Cimarex Energy Co. is an independent oil and gas exploration and production company. Our operations are presently focused primarily in Oklahoma, Texas, New Mexico, Kansas, Louisiana, and the Gulf of Mexico. We also have smaller projects underway in Michigan and California.

Our primary focus is to explore for and discover new reserves. To supplement our growth, we also consider mergers and acquisitions. On June 7, 2005, Cimarex acquired Magnum Hunter Resources, Inc, a Dallas-based independent oil and gas exploration and production company with operations concentrated in the Permian Basin of West Texas and New Mexico and in the Gulf of Mexico. Terms of the merger agreement provided that Magnum Hunter stockholders receive 0.415 shares of Cimarex common stock for each share of Magnum Hunter common stock. As a result of the merger, Cimarex issued 39.7 million common shares to Magnum Hunter's common stockholders (excluding 2.5 million shares held in treasury) and assumed \$633 million of debt. The merger was accounted for as a purchase of Magnum Hunter by Cimarex. Results of operations from Magnum Hunter's properties are included in our consolidated statements of operations beginning June 7, 2005.

As a result of the merger, our proved reserves tripled and production doubled. Our common shares outstanding increased by 93 percent to 82.4 million and we went from having no debt to taking on \$633 million of debt. Using proceeds from property sales and cash flow in excess of capital

investments, we reduced our debt to \$352 million by year end 2005. Debt at June 30, 2006 equals \$404 million. Operationally we now have a large base of properties in the Permian Basin with operational characteristics similar to our Mid-Continent assets. The merger also extended our onshore Gulf Coast activities into the Gulf of Mexico. Overall, about 44 percent of our proved reserves are in the Permian Basin and 39 percent are in our Mid-Continent region. Our onshore Gulf Coast and Gulf of Mexico operations collectively make up 12 percent of our proved reserves.

***Industry and Economic Factors***

In managing our business we must deal with many factors inherent in our industry. First and foremost is wide fluctuation of oil and gas prices. Historically, oil and gas markets have been cyclical and volatile, with future price movements difficult to predict. While our revenues are a function of both production and prices, wide swings in prices often have the greatest impact on our results of operations.

Our operations entail significant complexities. Advanced technologies requiring highly trained personnel are utilized in both exploration and production. Even when the technology is properly used, the interpreter still may not know conclusively if hydrocarbons will be present or the rate at which they will be produced. Exploration is a high-risk activity, often times resulting in no commercially productive reservoirs being discovered. Moreover, costs associated with operating within the industry are substantial and usually move up and down together with prices.

The oil and gas industry is highly competitive. We compete with major and diversified energy companies, independent oil and gas companies, and individual operators. In addition, the industry as a whole competes with other businesses that supply energy to industrial, commercial and residential end users.

Extensive federal, state and local regulation of the industry significantly affects our operations. In particular, our activities are subject to comprehensive environmental regulations. Compliance with these regulations increases the cost of planning, designing, drilling, installing, operating, and abandoning oil and gas wells and related facilities. These regulations may become more demanding in the future.

*Approach to the Business*

Profitable growth of our assets will largely depend upon our ability to successfully find and develop new proved reserves. To achieve an overall acceptable rate of growth, we maintain a blended portfolio of low, moderate and higher risk exploration and development projects. We believe that this approach allows for consistent increases in our oil and gas reserves, while minimizing the chance of failure. To further mitigate risk, we have chosen to seek geologic and geographic diversification by operating in multiple basins. We may also consider the use of transaction-specific hedging of oil and gas prices to reduce price risk. In connection with the acquisition of Magnum Hunter, we acquired existing commodity derivatives, as well as in July 2006, we entered into additional derivative contracts as discussed more fully below.

Implementation of our business approach relies on our ability to fund ongoing exploration and development projects with cash flow provided by operating activities, periodic sales of non-core properties and external sources of capital.



We project that 2006 exploration and development expenditures will approximate \$1 billion, up from the \$642 million invested in 2005. Approximately 30 percent of the expenditures will be in the Permian Basin, 29 percent in the Mid-Continent area, 22 percent in the Gulf Coast area and 15 percent in the Gulf of Mexico.

Exploration and development expenditures during the second quarter of 2006 totaled \$281.7 million, up from \$141.0 million for the second quarter of 2005. Capital expenditures for exploration and development during the first six months of 2006 were \$554.9 million, up from \$233.7 million during the first two quarters of 2005. In the first half of 2006, we participated in drilling 304 gross (188.9 net) wells, with an overall success rate of 89 percent.

Cash flow from operating activities for the six months ended June 30, 2006 totaled \$461.8 million, helping to fund our drilling program.

Based on expected cash provided by operating activities and monies available under our Senior Secured Revolving Credit Facility, we believe we are well positioned to fund the projects identified for the remainder of 2006 and beyond.

#### **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Our discussion and analysis of our financial condition and results of operation are based upon Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Our significant accounting policies are described in Note 4 to our Consolidated Financial Statements included in this report. In response to SEC Release No. 33-8040, *Cautionary Advice Regarding Disclosure about Critical Accounting Policies*, we have identified certain of these policies as being of particular importance to the portrayal of our financial position and results of operations and which require the application of significant judgment by our management. We analyze our estimates, including those related to oil and gas revenues, reserves and properties, as well as goodwill and contingencies, and base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our Consolidated Financial Statements.

##### ***Revenue Recognition***

Revenues from oil and gas sales are recognized based on the sales method, with revenue recognized on actual volumes sold to purchasers. There is a ready market for oil and gas, with sales occurring soon after production. We market and sell natural gas for working interest partners under short term sales and supply agreements and earn a fee for such services. Revenues are recognized as gas is delivered and are reflected net of gas purchases on the accompanying consolidated statement of operations.

*Oil and Gas Reserves*

The process of estimating quantities of oil and gas reserves is complex, requiring significant decisions in the evaluation of all available geological, geophysical, engineering and economic data. The data for a given field may also change substantially over time as a result of numerous factors including, but not limited to, additional development activity, evolving production history and continual reassessment of the viability of production under varying economic conditions. As a result, material revisions to existing reserve estimates may occur from time to time. Although every reasonable effort is made to ensure that reserve estimates reported represent the most accurate assessments possible, the subjective decisions and variances in available data for various fields make these estimates generally less precise than other estimates included in the financial statement disclosures. For 2005, revisions of reserve estimates resulted in an increase of 270 MBbls of oil and an increase of 9.5 Bcf of gas, representing less than half of a percent and one percent of proved oil and gas reserves, respectively, as of December 31, 2005.

We use the units-of-production method to amortize our oil and gas properties. Changes in reserve quantities will cause corresponding changes in depletion expense in periods subsequent to the quantity revision or, in some cases, a full cost ceiling limitation charge in the period of the revision. To date, changes in expense resulting from changes in previous estimates of reserves have not been material.

***Full Cost Accounting***

We use the full cost method of accounting for our oil and gas operations. All costs associated with property acquisition, exploration and development activities are capitalized. Exploration and development costs include dry hole costs, geological and geophysical costs, direct overhead related to exploration and development activities and other costs incurred for the purpose of finding oil and gas reserves. Salaries and benefits paid to employees directly involved in the exploration and development of properties, as well as other internal costs that can be directly identified with acquisition, exploration and development activities, are also capitalized.

Under full cost accounting rules, capitalized costs, less accumulated amortization and related deferred income taxes and excluding costs not subject to amortization, may not exceed an amount equal to the sum of the present value discounted at ten percent of estimated future net revenues less estimated future expenditures to be incurred in developing and producing the proved reserves, less any related income tax effects. Cash flows used in the calculation of the full cost ceiling limitation are determined based upon estimates of proved oil and gas reserves, current prices (as adjusted for the effect of cash flow hedges that qualify for hedge accounting treatment), and the costs to extract these reserves. Downward revisions in estimated reserve quantities, increases in future cost estimates or depressed oil and gas prices could cause us to reduce the carrying value of our oil and gas properties. If capitalized costs exceed this limit and excluding costs not subject to amortization, the excess must be charged to expense. This is referred to as the full cost ceiling limitation. The expense may not be reversed in future periods, even if higher oil and gas prices subsequently increase the full cost ceiling limitation. At the end of each quarter, a full cost ceiling limitation calculation is made.

***Goodwill***

We account for goodwill in accordance with Statement of Financial Accounting Standard (SFAS) No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 requires an annual impairment

assessment. A more frequent assessment is required if certain events occur that reasonably indicate an impairment may have occurred. The volatility of oil and gas prices may cause more frequent assessments. The impairment assessment requires us to make estimates regarding the fair value of goodwill. The estimated fair value is based on numerous factors, including future net cash flows of our estimates of proved reserves as well as the success of future exploration for and development of unproved reserves. These factors are each individually weighted to estimate the total fair value of goodwill. If the estimated fair value exceeds its carrying amount, goodwill is considered not impaired. If the carrying amount exceeds the estimated fair value, then a measurement of the loss must be performed, with any deficiency recorded as an impairment. We recorded \$45.0 million of goodwill in the purchase of Key on September 30, 2002 and \$685.4 million of goodwill in the purchase of Magnum Hunter on June 7, 2005.

*Allocation of Purchase Price*

The allocation of the Magnum Hunter purchase price to oil and gas properties utilized prevailing oil and gas prices at the time of negotiations and announcement of the merger. The overall allocation of the purchase price has been finalized and the goodwill amount related to the purchase as of June 30, 2006 was \$646.4 million.

*Derivatives*



SFAS No.133, *Accounting for Derivative Instruments and Hedging activities*, requires that all derivatives be recorded on the balance sheet at fair value. We generally determine the fair value of derivative contracts based on the stated contract prices and the current and projected underlying market prices at the determination date discounted to reflect the time value of money until settlement, using information we obtain from counter parties. Realized and unrealized gains and losses on derivatives that are not designated as hedges are recorded as an expense. In connection with the Magnum Hunter merger, Cimarex recognized a \$39.3 million net liability associated with Magnum Hunter's existing commodity derivatives at the merger date (June 7, 2005). These derivative instruments have not been designated for hedge accounting treatment. As a result, Cimarex recognized a net gain of \$18.8 million during the first six months of 2006. Activity includes both non-cash mark-to-market derivative gains and losses as well as cash settlements. Cash payments related to these contracts that settled in the first six months of 2006 totaled \$11.5 million. The net derivative liability at June 30, 2006 equals \$11.5 million. Cimarex will continue to recognize gains and losses in future earnings until the derivative instruments mature on December 31, 2006.

In July 2006, we entered into additional derivative contracts. These derivatives have been designated for hedge accounting treatment as cash flow hedges. Changes in fair value, to the extent the hedge is effective, will be recognized in other comprehensive income until the hedged item is settled and recognized in earnings. Hedge effectiveness is assessed at least quarterly based on total changes in the derivative's fair value. Any ineffective portion of the derivative instrument's change in fair value is recognized immediately in earnings.

### ***Contingencies***

A provision for contingencies is charged to expense when the loss is probable and the cost can be reasonably estimated. Determining when expenses should be recorded for these contingencies and

the appropriate amounts for accrual is a complex estimation process that includes subjective judgment. In many cases, this judgment is based on interpretation of laws and regulations, which can be interpreted differently by regulators and/or courts of law. We closely monitor known and potential legal, environmental and other contingencies and periodically determine when we should record losses for these items based on information available to us.

*Asset Retirement Obligations*

On January 1, 2003, we adopted SFAS No. 143, *Accounting for Asset Retirement Obligations*. This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The Statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made, and that the associated asset retirement costs be capitalized as part of the carrying amount of the long-lived asset. Oil and gas producing companies incur this liability which includes costs related to the plugging of wells, the removal of facilities and equipment, and site restorations, upon acquiring or drilling a successful well.

#### *Stock Options*

For periods prior to January 1, 2005, we applied Accounting Principles Board (APB) Opinion 25, *Accounting for Stock Issued to Employees*, and related interpretations to account for all stock option grants. No compensation cost had been recognized for stock options granted, as the option prices were equal to the market price of the underlying common stock on the date of grant.

Effective January 1, 2005, we adopted the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123R, *Share Based Payment* on a prospective basis. SFAS No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation to employees.

The fair value of each option award is estimated as of the date of grant using the Black-Scholes option-pricing model. Expected volatilities are based on the historical volatility of our common stock. Historical data is also used to estimate option exercise, expected years until exercise and employee termination within the valuation model. The risk free interest rate is based on U.S. Treasury Securities at a constant five year fixed maturity in effect at the date of the grant.

#### *Segment Information*

Cimarex has one reportable segment (exploration and production).

#### *Recent Accounting Developments*

In May 2006, the FASB proposed Staff Position No. AUG AIR-a, *Accounting for Planned Major Maintenance Activities*. This Interpretation would prohibit accruing as a liability the future costs of periodic major overhauls and maintenance of plant and equipment under the accrue-in-advance methodology, as the costs for future planned major maintenance activities do not meet the definition of a liability. The final Staff Position would be effective for fiscal years beginning after December 15, 2006.

In July 2006, the FASB issued Interpretation 48, *Accounting for Uncertainty in Income Taxes*, which defines the threshold for recognizing the benefits of tax-return positions in the financial



statements as more-likely-than-not to be sustained by the taxing authority. The term more-likely-than-not means a likelihood of more than 50 percent. The interpretation also requires quantitative and qualitative disclosures of estimates of tax benefits of positions taken for tax-return purposes that have not been recognized for financial reporting, if it is reasonably possible the estimates will significantly change in the twelve months after the balance sheet date. Along with these disclosures, a tabular presentation of significant changes during each period will be required. The Interpretation is effective as of the beginning of the first fiscal year beginning after December 15, 2006 (January 1, 2007 for calendar-year companies).

### *Overview*

Our results of operations are primarily impacted by changes in oil and gas prices and changes in our production volumes. Realized oil prices increased from \$50.56 per barrel in the second quarter of 2005 to \$65.67 per barrel in the second quarter of 2006. Realized gas prices decreased from \$6.49 per Mcf in the second quarter of 2005 to \$6.22 per Mcf in the second quarter of 2006.

Gas marketing revenues, net of related costs, pertain to sales of gas on behalf of third parties that are incidental to sales of our own production. Sales and costs associated with our production are reflected in gas sales and transportation expense.

We also own interests in gas gathering systems and gas processing plants that are connected to our production operations. We transport and process third party gas that is associated with our gas.

Transportation expenses are comprised of costs paid to carry and deliver oil and gas to a specified delivery point. In some cases we receive a payment from purchasers which is net of transportation costs, and in other instances we separately pay for transportation. If costs are netted in the proceeds received, both the gross revenues and gross costs are shown in sales and expenses, respectively.

Production costs are composed of lease operating expenses, which generally consist of pumpers' salaries, utilities, water disposal, maintenance and other costs necessary to operate our producing properties.

Taxes, other than income, are taxes assessed by state and local taxing authorities pertaining to production, revenues or the value of properties. These typically include production severance, ad valorem and excise taxes.

Depreciation, depletion and amortization of our producing properties is computed using the units-of-production method. Because the economic life of each producing well depends upon the assumed price for future sales of production, fluctuations in oil and gas prices may impact the level of proved reserves used in the calculation. Higher prices generally have the effect of increasing reserves, which reduces depletion, while lower prices generally have the effect of decreasing reserves, which increases depletion. In addition, changes in estimates of reserve quantities and estimates of future development costs or reclassifications from unproved properties to proved properties will impact depletion.

General and administrative expenses consist primarily of salaries and related benefits, office rent, legal fees, consultants, systems costs and other administrative costs incurred in our offices. While we expect such costs to increase with our growth, we expect such increases to be

proportionately smaller than our production growth. Expenses related to the merger are costs associated with the Magnum Hunter transaction.

Stock compensation expense consists of non-cash charges resulting from the issuance of restricted stock and restricted stock units to certain employees and the expensing of stock options resulting from the adoption of SFAS No. 123R.

*Basis of Presentation*

In June 2005, Cimarex acquired Magnum Hunter Resources, Inc, by issuing 0.415 shares of Cimarex common stock for each share of outstanding Magnum Hunter common stock, resulting in the issuance of 39.7 million Cimarex common shares. At June 30, 2006, Cimarex had 82.7 million shares outstanding. The merger was accounted for as a purchase of Magnum Hunter by Cimarex. The results of operations of Magnum Hunter were included in our consolidated statements of operations beginning June 7, 2005.

Certain amounts in prior years' financial statements have been reclassified to conform to the 2006 financial statement presentation. Most notably, the presentation of gas marketing and sales activities as discussed under *Revenue Recognition*.



**RESULTS OF OPERATIONS**

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Periods Ended June 30, 2006 Compared with Periods Ended June 30, 2005:

**SUMMARY DATA:**

| (in thousands or as indicated)                | For the Three Months<br>Ended<br>June 30, |            | For the Six Months<br>Ended<br>June 30, |            |
|---|---|------------|---|------------|
|   | 2006                                      | 2005       | 2006                                    | 2005       |
| Net income                                    | \$ 82,866                                 | \$ 52,477  | \$ 193,017                              | \$ 95,842  |
| Per share-basic                               | 1.01                                      | 1.01       | 2.35                                    | 2.04       |
| Per share-diluted                             | 0.98                                      | 0.98       | 2.27                                    | 1.98       |
| Gas sales                                     | \$ 191,658                                | \$ 137,159 | \$ 425,381                              | \$ 243,033 |
| Oil sales                                     | 108,838                                   | 47,862     | 197,110                                 | 79,370     |
| Total oil and gas sales                       | \$ 300,496                                | \$ 185,021 | \$ 622,491                              | \$ 322,403 |
| Total gas volume-Mcf                          | 30,818                                    | 21,143     | 63,333                                  | 38,779     |
| Gas volume-MMcf per day                       | 338.7                                     | 232.3      | 349.9                                   | 214.2      |
| Average gas price-per Mcf                     | \$ 6.22                                   | \$ 6.49    | \$ 6.72                                 | \$ 6.27    |
| Total oil volume-thousand barrels             | 1,657                                     | 947        | 3,139                                   | 1,613      |
| Oil volume-barrels per day                    | 18,213                                    | 10,402     | 17,343                                  | 8,911      |
| Average oil price-per barrel                  | \$ 65.67                                  | \$ 50.56   | \$ 62.79                                | \$ 49.21   |
| Gas gathering and processing revenues         | \$ 12,092                                 | \$ 2,697   | \$ 23,394                               | \$ 2,703   |
| Gas gathering and processing costs            | (6,386)                                   | (1,809)    | (12,939)                                | (1,862)    |
| Gas gathering and processing margin           | \$ 5,706                                  | \$ 888     | \$ 10,455                               | \$ 841     |
| Gas marketing revenues, net of related costs  | \$ 793                                    | \$ 340     | \$ 2,746                                | \$ 896     |
| <b>Costs and expenses:</b>                    |   |            |   |            |
| Depreciation, depletion and amortization      | \$ 94,773                                 | \$ 51,582  | \$ 185,401                              | \$ 89,667  |
| Production                                    | 43,804                                    | 17,412     | 85,576                                  | 27,583     |
| Transportation                                | 5,483                                     | 3,608      | 9,791                                   | 6,082      |
| Taxes other than income                       | 21,934                                    | 13,600     | 45,480                                  | 24,495     |
| General and administrative                    | 9,990                                     | 7,657      | 20,875                                  | 15,549     |
| Stock compensation                            | 2,096                                     | 1,213      | 4,064                                   | 2,438      |
| Expenses related to merger                    | (92)                                      | 6,685      | (61)                                    | 6,685      |
| Loss (gain) on derivative instruments         | (3,249)                                   | 2,030      | (18,816)                                | 2,030      |
| Interest expense, net of capitalized interest | 841                                       | 2,176      | 167                                     | 2,364      |
| Asset retirement obligation accretion         | 1,493                                     | 550        | 2,941                                   | 935        |
| Other income, net                             | (2,036)                                   | (2,915)    | (5,378)                                 | (4,156)    |

Net income for the second quarter of 2006 was \$82.9 million, or \$0.98 per diluted share, compared to net income of \$52.5 million, or \$0.98 per diluted share for the same period in 2005. For the six months ended June 30, 2006, net income was \$193.0 million, or \$2.27 per diluted share, compared to net income of \$95.8 million, or \$1.98 per diluted share, for the first six months of 2005. The change in net income results from the effect of changes in revenues and costs, as discussed further. The results of operations of Magnum Hunter are included in our consolidated statements of operations only for the period since the acquisition on June 7, 2005.

Oil and gas sales for the second quarter of 2006 totaled \$300.5 million, compared to \$185.0 million for the second quarter of 2005. The \$115.5 million increase in sales between the two periods results from \$16.8 million related to higher commodity prices and \$98.7 million due to higher production volumes (due primarily to increased production resulting from the acquisition of Magnum Hunter). For the six months ended June 30, 2006, oil and gas sales increased by \$300.1 million, or 93 percent, to \$622.5 million from \$322.4 million during the first six months of 2005. Higher production volumes increased sales by \$229.0 million and higher commodity prices contributed \$71.1 million to the increase between the two six-month periods.

Realized gas prices averaged \$6.22 per Mcf for the three months ended June 30, 2006, compared to \$6.49 per Mcf for the second quarter of 2005. This four percent change decreased sales by \$8.3 million between the two periods. Realized oil prices averaged \$65.67 per barrel for the second quarter of 2006, compared to \$50.56 per barrel for the same period in 2005. The increase in sales between periods resulting from this 30 percent improvement in oil prices totaled \$25.1 million.

For the six months ended June 30, 2006, realized gas prices increased to \$6.72 per Mcf from \$6.27 per Mcf realized in the first half of 2005. This price increase contributed \$28.5 million to the increase in sales between the two six-month periods. Realized oil prices averaged \$62.79 per barrel for the first half of 2006, compared to \$49.21 per barrel for the same period in 2005, resulting in a \$42.6 million increase in sales between periods. Changes in realized prices were the direct result of overall market conditions.

Sales also benefited from higher production volumes. Average gas volumes rose 106.4 MMcf per day in the second quarter of 2006 to 338.7 MMcf per day from 232.3 MMcf per day in the second quarter of 2005, resulting in \$62.8 million of incremental revenues. Oil volumes averaged 18,213 barrels per day for the second three months of 2006, compared to 10,402 barrels per day in the same period of 2005, resulting in increased revenues of \$35.9 million. For the first six months of 2006, gas volumes averaged 349.9 MMcf per day and oil volumes equaled 17,343 barrels per day, compared to first-half 2005 volumes of 214.2 MMcf per day and 8,911 barrels per day. The higher gas volumes increased sales between the two periods by \$153.9 million, and higher oil volumes resulted in \$75.1 million of additional revenues. The increase in sales volumes between the periods of 2006 and 2005 is due to positive drilling results during 2005 and the first half of 2006, and the inclusion of production from Magnum Hunter operations from June 7, 2005. Daily production volumes in the Gulf of Mexico and along the Texas and Louisiana Gulf Coast area were negatively impacted by approximately 10 to 15 MMcf equivalents during the second quarter of 2006 and 20 to 25 MMcf equivalents during the first quarter of 2006 as a result of hurricanes. No oil and gas reserves have been lost as a result of the storms and essentially all associated repair costs will be covered by insurance. The majority of these volumes were restored by the end of the second quarter.

Gas gathering and processing revenues, net of related costs, equaled \$5.7 million in the second quarter of 2006, compared to \$0.9 million in the second quarter of 2005. For the six months ended June 30, 2006 and 2005, such revenues net of related costs totaled \$10.5 million and \$0.8 million, respectively. The increase is due to the inclusion of related activities from Magnum Hunter operations. We own interests in gas gathering systems and gas processing plants that are connected to our production operations. We transport and process third party gas that is associated with our gas.

Gas marketing net revenues increased to \$0.8 million from \$0.3 million, net of related costs of \$29.8 million and \$62.2 million for the second quarters of 2006 and 2005, respectively. Gas marketing net revenues increased to \$2.7 million from \$0.9 million, net of related costs of \$87.0

million and \$115.4 million for the first six months of 2006 and 2005, respectively. Gas marketing revenues, net of related costs, pertain to sales of gas on behalf of third parties that is incidental to sales of our own production.

#### *Costs and Expenses*

Net costs and expenses (not including gas gathering, marketing and processing costs) were \$175.0 million in the second quarter of 2006 compared to \$103.6 million in the second quarter of 2005. For the first six months of 2006 and 2005, these overall costs and expenses equaled \$330.0 million and \$173.7 million, respectively. Depreciation, depletion and amortization (DD&A) was the largest component of these increases between periods. DD&A equaled \$94.8 million in the second quarter of 2006 compared to \$51.6 million in the same period of 2005. For the first six months of 2006 and 2005, DD&A totaled \$185.4 million and \$89.7 million, respectively. On a unit of production basis, DD&A was \$2.33 per Mcfe in the second quarter of 2006 compared to \$1.92 per Mcfe for the second quarter of 2005. For the first six months of 2006 and 2005, DD&A on a unit of production basis equaled \$2.26 per Mcfe and \$1.85 per Mcfe, respectively. The increases largely stem from costs associated with Magnum Hunter operations and higher costs for reserves added during 2005 and 2006.

Production costs rose \$26.4 million from \$17.4 million (\$0.65 per Mcfe) in the second three months of 2005 to \$43.8 million (\$1.07 per Mcfe) in the second quarter of 2006. For the first six months of 2006 and 2005, production costs equaled \$85.6 million (\$1.04 per Mcfe) and \$27.6 million (\$0.57 per Mcfe), respectively. The higher costs in 2006 resulted primarily from the inclusion of costs associated with Magnum Hunter operations, higher field operating expenses from an expanded number of properties, and higher maintenance costs.

Transportation costs increased from \$3.6 million, or \$0.14 per Mcfe, in the second quarter of 2005 to \$5.5 million, or \$0.14 per Mcfe, in the second quarter of 2006. Transportation costs for the first half of 2006 equaled \$9.8 million compared to \$6.1 million for the same period in 2005. The increase is the result of expiring contracts being renewed with increased current market rates, and the inclusion of transportation costs associated with Magnum Hunter operations.

Taxes other than income were \$8.3 million greater, rising from \$13.6 million in the second quarter of 2005 to \$21.9 million in the same period of 2006. For the first six months of 2006 and 2005, these costs totaled \$45.5 million and \$24.5 million, respectively. The increases between periods resulted from increases in oil and gas sales stemming from inclusion of Magnum Hunter operations, higher production volumes and commodity prices.

General and administrative (G&A) expenses increased \$2.3 million from \$7.7 million in the second quarter of 2005 to \$10.0 million in the second quarter of 2006. G&A expenses for the first half of 2006 equaled \$20.9 million compared to \$15.5 million for the same period of 2005. The increases between periods are due to an expansion of staff and higher employee-benefit costs.

Stock compensation expense consists of non-cash charges resulting from the issuance of restricted stock, restricted stock units and stock option awards net of amounts capitalized. Stock compensation increased from \$2.4 million in the first half of 2005 to \$4.1 million in the first half of 2006. As of June 30, 2006, there was approximately \$32.7 million of total unrecognized compensation cost related to compensation awards granted under our stock incentive plans.

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As of June 30, 2005, expenses associated with the Magnum Hunter merger totaled \$6.7 million. Of the \$6.7 million, \$3.6 million was due to the acceleration of vesting of stock options and restricted

stock units resulting from change of control provisions under our stock incentive plan becoming effective due to the Magnum Hunter merger. The remaining \$3.1 million consisted of \$1.6 million of general integration costs, \$1.0 million for retention bonuses, and \$0.5 million of related financing costs.

Another component of net costs and expenses for 2006 was the gain on derivative instruments. In connection with the Magnum Hunter merger, we recognized a \$39.3 million net liability associated with Magnum Hunter's existing commodity derivatives at the merger date (June 7, 2005). These derivative instruments have not been designated for hedge accounting treatment. As a result, Cimarex recognized in earnings during the second quarter and first six months of 2006 a net gain of \$3.2 million and \$18.8 million, respectively, compared to a loss of \$2.0 million in the periods of 2005. Activity includes both non-cash mark-to-market derivative losses as well as cash settlements. Cash payments related to these contracts that settled in the first six months of 2006 totaled \$11.5 million. The net derivative liability at June 30, 2006 equals \$11.5 million. Cimarex will continue to recognize mark-to-market gains and losses as well as amortization of these contracts in future earnings until the derivative instruments mature. In July 2006, we entered into additional derivative contracts. These derivatives have been designated for hedge accounting treatment as cash flow hedges. Changes in fair value, to the extent the hedge is effective, will be recognized in other comprehensive income until the hedged item is settled and recognized in earnings. Hedge effectiveness is assessed at least quarterly based on total changes in the derivative's fair value. Any ineffective portion of the derivative instrument's change in fair value is recognized immediately in earnings.

Net interest expense in the second quarter of 2006 of \$0.8 million is comprised of \$6.4 million of interest expense, offset by \$5.6 million of capitalized interest resulting from interest recognized on borrowings associated with costs incurred to bring properties under development, not being amortized, to their intended use. Net interest expense in the first half of 2006 of \$0.2 million is comprised of \$12.0 million of interest expense, offset by \$11.8 million of capitalized interest. The additional components of the 2006 net interest amount and the increase from 2005 results from amounts associated with the debt assumed in the Magnum Hunter merger. Prior to the Magnum Hunter merger, Cimarex had no outstanding debt.

#### *Income tax expense*

Income tax expense totaled \$49.1 million for the second quarter of 2006 versus \$30.2 million for the second three months of 2005. Tax expense equaled a combined Federal and state effective income tax rate of 37.2 percent and 36.5 percent in the second quarters of 2006 and 2005, respectively. Income tax expense for the first six months of 2006 equaled \$112.6 million compared to \$54.6 million for the same period of 2005, equating to combined Federal and state effective income tax rates of 36.9 percent and 36.3 percent, respectively. We estimate that \$4.3 million of our first-half 2006 income tax expense is current.

## **LIQUIDITY AND CAPITAL RESOURCES**

### *Cash Flows*

Our primary source of capital is cash flow generated from operating activities. Prices we receive for oil and gas sales and our level of production will impact these future cash flows. No prediction can be made as to the prices we will receive. Production volumes will in large part be dependent upon the amount and results of future capital expenditures. In turn, actual levels of capital expenditures

may vary due to many factors, including drilling results, oil and gas prices, industry conditions, prices and availability of goods and services, and the extent to which proved properties are acquired.

Cash flow provided by operating activities for the first six months of 2006 was \$461.8 million, compared to \$199.2 million for the first six months of 2005. The increase in 2006 from the earlier period resulted primarily from higher oil and gas production and prices and the acquisition of Magnum Hunter.

Higher revenues from oil and gas sales facilitated the funding of our exploration and development expenditure program for the first six months of 2006.

Cash flow used in investing activities for the first six months of 2006 was \$556.0 million, compared to \$201.1 million for the first six months of 2005. The increase in 2006 stemmed from a larger exploration and development program.

Cash flow provided by financing activities in the first half of 2006 was \$38.0 million versus \$56.6 million used in the first half of 2005. The cash provided in financing activities in 2006 resulted from \$53.0 million of borrowings on long-term debt and \$2.6 million of proceeds from the issuance of common stock from stock option exercises, offset by \$11.0 million of treasury stock acquired and \$6.6 million of dividends paid. The cash used in financing activities in 2005 resulted primarily from the payment of \$60.1 million on debt assumed in the Magnum Hunter acquisition.

***Financial Condition***



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As of June 30, 2006, stockholders' equity totaled \$2.8 billion, up from \$2.6 billion at December 31, 2005. The increase resulted primarily from first-half 2006 net income of \$193.0 million. At June 30, 2006 our cash balance equaled \$5.4 million.

In December 2005, the Board of Directors declared the Company's first quarterly dividend of \$.04 per share payable on March 1, 2006 to shareholders of record as of February 15, 2006. In March 2006, a second quarterly dividend of \$.04 per share was declared, payable on June 1, 2006 to shareholders of record as of May 15, 2006. In May 2006 a third quarterly dividend of \$.04 per share was declared, payable on September 1, 2006 to shareholders of record as of August 15, 2006.

In December 2005, the Board of Directors authorized the repurchase of up to four million shares of common stock. Through December 31, 2005, 68,000 shares had been repurchased at an average price of \$43.03. Since December 31, 2005 and through June 2006, an additional 182,100 shares have been repurchased for an average price of \$44.43 per share.

### *Working Capital*

Working capital at June 30, 2006 was a negative \$12.9 million, compared to a positive \$31.6 million at December 31, 2005. The decrease is primarily the result of a decrease in cash and net receivables. Our receivables are from a diverse group of companies including major energy companies, pipeline companies, local distribution companies and end-users in various industries. The collection of receivables during the period presented has been timely. Historically, losses associated with uncollectible receivables have not been significant.

*Financing*

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Prior to the Magnum Hunter merger, Cimarex had no debt. Debt at December 31, 2005 consisted of the following (in thousands):

|   |    |            |
|---|----|------------|
| Bank debt   | \$ |            |
| 9.6% Notes due 2012 (face value \$195,000)                      |    | 213,770(1) |
| Floating rate convertible notes due 2023 (face value \$125,000) |    | 138,681(2) |
| Total long-term debt  | \$ | 352,451    |

Debt at June 30, 2006 consisted of the following (in thousands):

|  |    |            |
|--|----|------------|
| Bank debt  | \$ | 53,000     |
| 9.6% Notes due 2012 (face value of \$195,000)  |    | 212,258(1) |
| Floating rate convertible notes due 2023, 5.33% at June 30, 2006 (face value of \$125,000) |    | 138,302(2) |
| Total long-term debt   | \$ | 403,560    |

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(1) Fair market value at June 7, 2005 (date of acquisition of Magnum Hunter) equaled \$215.5 million. The subsequent noted balances represent the fair market value at date of acquisition less amortization of the premium of fair market value over face value.

(2) Fair market value at June 7, 2005 equaled \$144.75 million. The subsequent noted balances represent the fair market value at date of acquisition less amortization of the premium of fair market value over face value. Paid-in-Capital includes \$49.6 million related to the fair value of common stock associated with the convertible debt.

Cimarex's Revolving Credit Facility provides for \$500 million of long-term committed credit. The facility is scheduled to mature on July 1, 2010 and is secured by mortgages on certain oil and gas properties and the stock of certain wholly-owned operating subsidiaries. At June 30, 2006, there were outstanding borrowings of \$53 million under the Revolving Credit Facility at a weighted average interest rate of approximately 6.43%. We also had letters of credit for approximately \$2.7 million posted against the borrowing base, leaving an unused borrowing amount of approximately \$444.3 million at June 30, 2006.

The Credit Facility agreement contains both financial and non-financial covenants. Cimarex continues to comply with these covenants and does not view them as materially restrictive.

The 9.6% notes assumed in the Magnum Hunter merger have a face value of \$195 million and are due March 15, 2012. The notes are unsecured and are redeemable, as a whole or in part, at Cimarex's option, on and after March 15, 2007 at the following redemption prices (expressed as percentages of the principal amount), plus accrued interest, if any, thereon to the date of redemption.

| Year                | Percentage |
|---------------------|------------|
| 2007                | 104.8%     |
| 2008                | 103.2%     |
| 2009                | 101.6%     |
| 2010 and thereafter | 100.0%     |

The floating rate convertible senior notes were assumed in the Magnum Hunter merger and mature on December 15, 2023. The notes are senior unsecured obligations and bear interest at an annual rate equal to three-month LIBOR, reset quarterly. On June 30, 2006, the interest rate equaled 5.33%.

Holder of the convertible notes may surrender their notes for conversion into a combination of cash and shares of our common stock upon the occurrence of certain circumstances, including if the price of our common stock has been trading above the fixed conversion price of \$28.99 per share. On June 30, 2006, the closing price of our common stock traded on the New York Stock Exchange was \$43.00. There is not an observable market for the notes. Based on an average common stock price of \$43.00, management estimates the fair value of the notes at June 30, 2006 was approximately \$185.4 million (or \$1,480 per bond). The common stock component of the convertible debt has been included in stockholders equity.

In addition to the holder's right to redeem the notes if our common stock price is above the conversion price, the holders also have the right to require Cimarex to repurchase all or a portion of the notes at a repurchase price equal to 100% of the principal amount (plus accrued interest) on December 15, 2008, 2013 and 2018. The indenture agreement also provides Cimarex with an option to redeem some or all of the notes at a redemption price equal to 100% of the principal amount (plus accrued interest) anytime after December 22, 2008.

All long-term debt is guaranteed by Cimarex and all of its subsidiaries, except Canvasback. Assets held by Canvasback consist primarily of 790 thousand shares of Cimarex stock, which is included in Cimarex's Treasury stock.

Total borrowings at June 30, 2006 on the construction loan of Magnum Hunter's 40% owned affiliate, Apple Tree Holdings, LLC ( Apple Tree ) were \$20.6 million, of which our share was \$8.2 million. We have provided a guarantee to the lender for this Construction Loan. In return for our guarantee, we received an up-front fee as well as the right to receive 55% of distributable cash flows from Apple Tree until certain financial tests are met. In the event that the Construction Loan goes into default and we have to perform under the guarantee, we will have recourse against the project and related subsidiaries.

*Contractual Obligations and Material Commitments*

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At June 30, 2006, we had contractual obligations and material commitments as follows:

| Contractual obligations         | Total      | Payments Due by Period<br>(In thousands) |              |              |                      |
|---------------------------------|------------|--|--------------|--------------|----------------------|
|                                 |            | Less than<br>1 Year                      | 1-3<br>Years | 3-5<br>Years | More than<br>5 Years |
| Long-term debt (1)              | \$ 373,000 | \$                                       | \$           | \$           | \$ 373,000           |
| Fixed-Rate interest payments(1) | 112,320    | 18,720                                   | 37,440       | 37,440       | 18,720               |
| Commodity derivatives           | 11,470     | 11,470                                   |              |              |                      |
| Operating leases                | 33,285     | 4,852                                    | 10,185       | 8,276        | 9,972                |
| Drilling commitments            | 69,489     | 69,489                                   |              |              |                      |
| Asset retirement obligation     | 113,592    | 4,319                                    | (2)          | (2)          | (2)                  |
| Other liabilities               | 6,062      | 32                                       | 183          | 150          | 5,697                |

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(1) See item 3: Interest Rate Risk for more information regarding fixed and variable rate debt.

(2) We have excluded the long term asset retirement obligations because we are not able to precisely predict the timing of these amounts.



At June 30, 2006, we had firm sales contracts to deliver approximately 2.8 Bcf of natural gas over the next four months. If this gas is not delivered, our financial commitment would be approximately \$14.9 million. This commitment will fluctuate due to price volatility and actual volumes delivered. However, we believe no financial commitment will be due based on our reserves and current production levels.

Cimarex has other various delivery commitments in the normal course of business, none of which are individually material. In aggregate these commitments have a maximum amount that would be payable, if no gas is delivered, of approximately \$3.6 million.

All of the noted commitments were routine and were made in the normal course of our business.

Based on current commodity prices and anticipated levels of production, we believe that the estimated net cash generated from operations, coupled with the cash on hand and amounts available under our existing line of credit will be adequate to meet future liquidity needs, including satisfying our financial obligations and funding our operations and exploration and development activities.

#### *2006 Outlook*

Our projected 2006 exploration and development expenditure program of approximately \$1 billion will require a great deal of coordination and effort. Though there are a variety of factors that could curtail, delay or even cancel some of our drilling operations, we believe our projected program has a high degree of occurrence. The majority of projects are in hand, drilling rigs are being scheduled, and the historical results of our drilling efforts in these areas warrant pursuit of the projects.

Costs of operations on a per Mcfe basis for 2006 are estimated to approximate levels realized in late 2005. Should factors beyond our control change, our program and realized costs will vary from current projections. These factors could include volatility in commodity prices, changes in the supply of and demand for oil and gas, weather conditions, governmental regulations and more.

Production estimates for 2006 range from 455 to 465 MMcfe per day. Revenues will be dependent not only on the level of oil and gas actually produced, but also the prices that will be realized. During 2005, our realized prices averaged \$8.05 per Mcf of gas and \$55.25 per barrel of oil. Prices can be very volatile and the possibility of 2006 realized prices being less than they were in 2005 is high.

### **ITEM 3. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK**

#### *Price Fluctuations*

Our results of operations are highly dependent upon the prices we receive for oil and gas production, and those prices are constantly changing in response to market forces. Nearly all of our revenue is from the sale of oil and gas, so these fluctuations, positive and negative, can have a significant impact on our results of operations and cash flows.

Monthly gas price realizations during the second quarter of 2006 ranged from \$5.61 per Mcf to \$6.58 per Mcf. Oil prices ranged from \$63.15 per barrel to \$66.92 per barrel. Monthly gas price realizations during the first half of 2006 ranged from \$5.61 per Mcf to \$8.43 per Mcf. Oil prices for the first half of 2006 ranged from \$58.10 per barrel to \$66.92 per barrel. It is impossible to predict future oil and gas prices with any degree of certainty.

SFAS No.133, Accounting for Derivative Instruments and Hedging activities, requires that all derivatives be recorded on the balance sheet at fair value. We generally determine the fair value of derivative contracts based on the difference between the floor or ceiling contract prices and the underlying market price at the determination date. Realized and unrealized gains and losses on derivatives that are not designated as hedges are recorded as an expense. In connection with the Magnum Hunter merger, Cimarex recognized a \$39.3 million net liability associated with Magnum Hunter's existing commodity derivatives at the merger date (June 7, 2005). These derivative instruments have not been designated for hedge accounting treatment. As a result, Cimarex recognized in earnings during the first half of 2006 a net gain of \$18.8 million. Activity includes both non-cash mark-to-market derivative gains and losses as well as cash settlements. Cash payments related to these contracts that settled in the first half of 2006 totaled \$11.5 million. The net derivative liability at June 30, 2006 equals \$11.5 million. Actual gains and losses to be recognized in the future may differ materially, arising from movements in the prices of oil and natural gas. Cimarex will continue to recognize gains and losses in future earnings until the derivative instruments mature. Actual gains and losses to be recognized may differ materially from current fair value estimates.

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The following is a summary of the company's open derivative contracts as of June 30, 2006:

| Commodity   | Type   | Volume/Day   | Duration |        | Nymex<br>Weighted Average<br>Price | Fair Value<br>(000 \$) |
|-------------|--------|--------------|----------|--------|------------------------------------|------------------------|
| Natural Gas | Collar | 20,000 MMBTU | July 06  | Dec 06 | \$5.25 - \$6.30                    | \$ (4,293)             |
| Crude Oil   | Collar | 1,000 BBL    | July 06  | Dec 06 | \$30.00 - \$35.85                  | (7,178)                |
|             |        |              |          |        |                                    | \$ (11,471)            |

All of the \$11.5 million of derivative liabilities is classified as current on our consolidated balance sheet at June 30, 2006. Weighted average NYMEX prices at June 30, 2006 for the remaining six months of 2006 approximate \$7.15 per Mcf of gas and \$75.40 per barrel of oil.

In July 2006, we entered into additional derivative contracts. These derivatives have been designated for hedge accounting treatment as cash flow hedges. Changes in fair value, to the extent the hedge is effective, will be recognized in other comprehensive income until the hedged item is settled and recognized in earnings. Hedge effectiveness is assessed at least quarterly based on total changes in the derivative's fair value. Any ineffective portion of the derivative instrument's change in fair value is recognized immediately in earnings. The table below sets forth the weighted average terms of the related derivative contracts through August 1, 2006.

| Commodity   | Type    | Volume/Day   | Duration |        | Mid Continent<br>Weighted Average<br>Price |
|-------------|---------|--------------|----------|--------|--|
| Natural Gas | Collars | 70,000 MMBTU | Jan 07   | Dec 07 | \$7.00 - \$10.05                           |
| Natural Gas | Collars | 40,000 MMBTU | Jan 08   | Dec 08 | \$7.00 - \$9.90                            |

Any sustained weakness in prices may affect our financial condition and results of operations, and may also reduce the amount of net oil and gas reserves that we can produce economically. Any reduction in reserves, including reductions due to price fluctuations, can have an adverse effect on our ability to obtain capital for exploration and development and could cause us to record a reduction in the carrying value of our oil and gas properties.

**Interest Rate Risk**

*Fixed and Variable Rate Debt.* Cimarex assumed fixed and variable rate debt as part of the acquisition of Magnum Hunter. These agreements expose the company to market risk related to changes in interest rates. The company has a credit facility that bears interest at either a Base rate or a Eurodollar rate at the Company's option.

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The following table presents the carrying and fair value of the company's debt along with average interest rates as of June 30, 2006. The fair value for the Convertible Notes was based on an average price per share of \$43.00 for Cimarex common stock. The fair value for the fixed rate Senior Notes was based on their last traded value before June 30, 2006.

| Expected Maturity Dates<br>(in thousands of dollars) | 2010      | 2012       | 2023       | Total      | Book Value | Fair Value |
|--|-----------|------------|------------|------------|------------|------------|
| <b>Variable Rate Debt:</b>                           |           |            |            |            |            |            |
| Bank debt (a)  | \$ 53,000 | \$         | \$         | \$ 53,000  | \$ 53,000  | \$ 53,000  |
| Convertible Notes (b)                                | \$        | \$         | \$ 125,000 | \$ 125,000 | \$ 138,302 | \$ 185,409 |
| <b>Fixed Rate Debt:</b>                              |           |            |            |            |            |            |
| Senior Notes (c)                                     | \$        | \$ 195,000 | \$         | \$ 195,000 | \$ 212,258 | \$ 206,213 |

- (a) At June 30, 2006, the weighted average interest rate on outstanding borrowings under the credit facility was approximately 6.43%.
- (b) The interest rate on the convertible notes is 5.33%. The rate on these notes is equal to the three month LIBOR, adjusted quarterly. A holder of these notes has the right to require us to repurchase all or a portion of these notes on December 15, 2008, 2013, and 2018. The repurchase will be equal to the face value of the notes plus accrued and unpaid interest up to the date of repurchase. Included in Paid in Capital is \$49.6 million related to the fair value of common stock associated with the convertible debt.
- (c) The interest rate on the senior notes due 2012 is a fixed 9.6%.

**ITEM 4. CONTROLS AND PROCEDURES**

*EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES*



Cimarex's management, with the participation of the Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), have evaluated the effectiveness of Cimarex's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e)) as of June 30, 2006 and concluded that the disclosure controls and procedures are effective in providing reasonable assurance that the information required to be disclosed in reports filed with the SEC is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. The disclosure controls and procedures are also designed to provide reasonable assurance that such information is accumulated and communicated to our management, including the CEO and CFO, as appropriate to allow such persons to make timely decisions regarding required disclosures.

Our management does not expect that our disclosure controls and procedures will prevent all errors and all fraud. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Based on the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple errors or mistakes. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is also based upon certain assumptions about the likelihood of future events. Therefore, a control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Our disclosure controls and procedures are designed to provide such reasonable assurances of achieving our desired control objectives, and our CEO and CFO have concluded, as of June 30, 2006, that our disclosure controls and procedures are effective in achieving that level of reasonable assurance.

#### *CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING*

There have been no changes in our internal controls over financial reporting or in other factors that occurred during the fiscal quarter ended June 30, 2006, that have materially affected or are reasonably likely to materially affect our internal controls over financial reporting.

**PART II****ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

The annual meeting of Cimarex was held on May 17, 2006. Three proposals were voted upon at the annual meeting. There were no broker non-votes. Following are the results of voting on each proposal:

Proposal 1. Election of four directors as Class I directors with terms expiring in 2009.

|                     | <b>For</b> | <b>Against</b> |
|---------------------|------------|----------------|
| Jerry Box           | 73,807,276 | 4,753,831      |
| Paul D. Holleman    | 73,508,988 | 4,052,119      |
| F. H. Merelli       | 73,154,602 | 4,406,505      |
| Michael J. Sullivan | 72,980,803 | 4,580,304      |

In addition to the four Class I directors noted above, the other directors of Cimarex whose terms have not expired include: Glenn A. Cox, Cortlandt S. Dietler, Hans Helmerich, David A. Hentschel, Monroe W. Robertson and L. Paul Teague.

Proposal 2. Approve performance goals applicable to awards of restricted stock in order to obtain the federal income tax deduction benefits under Section 162m of the Internal Revenue Code.

| <b>For</b> | <b>Against</b> | <b>Abstain</b> |
|------------|----------------|----------------|
| 70,771,110 | 3,770,348      | 3,019,649      |

Proposal 3. Ratify the appointment of KPMG LLP as independent auditors for 2006.

| <b>For</b> | <b>Against</b> | <b>Abstain</b> |
|------------|----------------|----------------|
| 73,821,707 | 532,135        | 3,207,265      |

**ITEM 6 EXHIBITS**

(a)

- 31.1 Certification of F. H. Merelli, Chief Executive Officer of Cimarex Energy Co. pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Paul Korus, Chief Financial Officer of Cimarex Energy Co. pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of F. H. Merelli, Chief Executive Officer of Cimarex Energy Co. pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.
- 32.2 Certification of Paul Korus, Chief Financial Officer of Cimarex Energy Co. pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.

(b) Forms 8-K filed during quarter ended June 30, 2006:

| Date Filed     | Items Reported  |
|----------------|---|
| April 25, 2006 | Update on oil and gas production volumes              |
| May 5, 2006    | First Quarter Earnings                                |
| May 19, 2006   | Declaration of Quarterly Dividend                     |
| May 23, 2006   | Grant of Restricted Stock to Non-Management Directors |

**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.

August 3, 2006

CIMAREX ENERGY CO.

/s/ Paul Korus  
Paul Korus  
Vice President, Chief Financial Officer and Treasurer  
(Principal Financial Officer)

/s/ James H. Shonsey  
James H. Shonsey  
Vice President, Chief Accounting Officer and Controller  
(Principal Accounting Officer)