

Citadel Exploration, Inc.
Form 10-Q
August 15, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended June 30, 2016

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

Commission file number 000-54639

CITADEL EXPLORATION, INC.

(Exact name of registrant as specified in its charter)

Nevada

(State or other jurisdiction of
incorporation or organization)

27-1550482

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

417 31st Street, Unit A, Newport Beach, CA 92663

(Address of principal executive offices) (Zip Code)

(949) 612-8040

(Registrant's telephone number, including area code)

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

Yes No

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

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Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer company

Smaller reporting company

(Do not check if a smaller reporting company)

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

Yes No

The number of shares of Common Stock, \$0.001 par value, outstanding on August 15, 2016 was 38,814,000 shares.

CITADEL EXPLORATION, INC.

QUARTERLY PERIOD ENDED JUNE 30, 2016

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

	June 30, 2016 (unaudited)	December 31, 2015
ASSETS		
Current assets:		
Cash	\$38,425	\$146,555
Other receivable	1,209	19,342
Prepaid expenses	91,663	29,870
Product inventory	4,881	4,881
Total current assets	136,178	200,648
Deposits	9,900	9,900
Restricted cash	245,000	245,000
Oil and gas properties, successful efforts basis	5,579,945	4,173,307
Fixed asset, net	10,119	13,860
Total assets	\$5,981,142	\$4,642,715
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	\$1,552,647	\$1,047,169
Accrued interest payable	349,589	227,945
Notes payable, net	564,202	525,034
Notes payable, related party, net	—	3,500,000
Total current liabilities	2,466,438	5,300,148
Asset retirement obligation	201,455	198,279
Production payment liability	300,000	300,000
Total liabilities	2,967,893	5,798,427
Stockholders' equity (deficit):		
Common stock, \$0.001 par value, 100,000,000 shares authorized, 38,814,000 and 38,814,000 shares issued outstanding as of June 30, 2016 and December 31, 2015, respectively	38,814	38,814
Series A Preferred stock	4,925,000	—

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Additional paid-in capital	5,690,560	5,690,560
Accumulated deficit	(7,641,125)	(6,885,086)
Total stockholders' equity (deficit)	3,013,249	(1,155,712)
Total liabilities and stockholders' equity (deficit)	\$5,981,142	\$4,642,715

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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CITADEL EXPLORATION, INC.
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
(unaudited)

	For the three months ended June 30,		For the six months ended June 30,	
	2016	2015	2016	2015
Revenue	\$6,006	\$40,112	\$26,762	\$60,141
Operating expenses:				
Lease operating expense	30,326	14,504	110,084	26,162
General and administrative	61,673	131,828	131,057	187,714
Depreciation, amortization and accretion	4,110	3,835	9,151	7,671
Professional fees	91,639	6,357	138,259	18,236
Executive compensation	125,652	162,088	261,699	324,177
Total operating expenses	313,400	318,612	650,250	563,961
Loss from operations	(307,394)	(278,500)	(623,488)	(503,820)
Other expenses:				
Loss – Contingency	—	—	—	(87,000)
Loss - note payable settlement	—	—	—	(26,080)
Interest expense	(14,245)	(16,358)	(132,553)	(36,266)
Total other expenses	(14,245)	(16,358)	(132,553)	(149,316)
Loss before provision for income taxes	(321,639)	(294,858)	(756,039)	(653,136)
Provision for income taxes	—	—	—	—
Net loss	\$(321,639)	\$(294,858)	\$(756,039)	\$(653,135)
Weighted average number of common shares - outstanding - basic and diluted	34,937,077	32,814,000	34,937,077	32,105,436
Net loss per share – basic and diluted	\$(0.01)	\$(0.01)	\$(0.02)	\$(0.02)

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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

	For the six months Ended June 30,	
	2016	2015
OPERATING ACTIVITIES		
Net loss	\$(756,039)	\$(653,135)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation, amortization and accretion	9,151	7,778
Amortization of debt discount	1,832	7,467
Loss on settlement of note payable	—	26,080
Stock based compensation expense	—	74,997
Loss contingency	—	87,000
Changes in operating assets and liabilities:		
Increase/(Decrease) in other receivable	18,133	1
Increase in prepaid expenses	(61,793)	25,827
Decrease in deposits	—	(105,000)
Increase in accounts payable and accrued payables	505,479	98,319
Increase in accrued interest payable	121,644	67,163
Net cash used in operating activities	(161,593)	(363,499)
INVESTING ACTIVITIES		
Oil and gas properties	(1,408,873)	(176,762)
Net cash used in investing activities	(1,408,873)	(176,762)
FINANCING ACTIVITIES		
Proceeds from sale of common stock, net of costs	—	107,836
Proceeds from sale of preferred stock, net of costs	1,425,000	
Proceeds from notes payable	68,736	200,000
Repayments for notes payable	(31,400)	(10,230)
Net cash provided by financing activities	1,462,336	297,606
NET DECREASE IN CASH	(108,130)	(242,655)
CASH AT BEGINNING OF YEAR	146,555	270,298
CASH AT END OF PERIOD	\$38,425	\$27,641
SUPPLEMENTAL INFORMATION:		
Interest paid	\$—	\$(651)
Income taxes paid	\$—	\$—

NON-CASH INVESTING AND FINANCING ACTIVITIES:

Issuance of preferred stock for settlement of note payable – related party	\$3,500,000	
Issuance of common stock for settlement of note payable and accrued interest	\$—	\$25,494

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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CITADEL EXPLORATION, INC.

Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation

The interim condensed consolidated financial statements included herein, presented in accordance with United States generally accepted accounting principles and stated in US dollars, have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading.

These statements reflect all adjustments, consisting of normal recurring adjustments, which in the opinion of management, are necessary for fair presentation of the information contained therein. It is suggested that these interim condensed consolidated financial statements be read in conjunction with the financial statements of the Company for the year ended December 31, 2015 and notes thereto included in the Company's 10-K annual report and all amendments. The Company follows the same accounting policies in the preparation of interim reports.

Results of operations for the interim period are not indicative of annual results.

Principles of consolidation

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

Nature of operations

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

Revenue Recognition

Sales of oil are recognized when the product has been delivered to a custody transfer point, persuasive evidence of a sales arrangement exists, the rights and responsibility of ownership pass to the purchaser upon delivery, collection of revenue from the sale is reasonably assured, and the sales price is fixed or determinable.

Impairment

The Company evaluates the impairment of its proved oil and natural gas properties on a field-by-field basis whenever events or changes in circumstances indicate that the carrying value may not be recoverable. The carrying values of proved properties are reduced to fair value when the expected undiscounted future cash flows are less than net book value. The fair values of proved properties are measured using valuation techniques consistent with the income approach, converting future cash flows to a single discounted amount. Significant inputs used to determine the fair values of proved properties include estimates of: (i) reserves; (ii) future operating and development costs; (iii) future commodity prices; and (iv) a market-based weighted average cost of capital rate.

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CITADEL EXPLORATION, INC.

Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Use of estimates

The preparation of condensed consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ significantly from those estimates.

Fair value of financial instruments

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

Cash and cash equivalents

The Company considers all highly liquid instruments with maturity of three months or less at the time of issuance to be cash equivalents. The Company had no cash equivalents as of June 30, 2016 and December 31, 2015.

Earnings per share

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

Recent pronouncements

The Company has evaluated the recent accounting pronouncements through June 30, 2016 and believes that none of them will have a material effect on the company's condensed consolidated financial statements.

NOTE 2 – GOING CONCERN

The accompanying unaudited condensed consolidated financial statements have been prepared assuming that the Company will continue as a going concern, which contemplates the recoverability of assets and the satisfaction of liabilities in the normal course of business. Since its inception, the Company has been engaged substantially in financing activities and developing its business plan and incurring startup costs and expenses. As a result, the Company incurred an accumulated deficit in the amount of \$7,641,125 as of June 30, 2016. In addition, the Company's development activities since inception have been financially sustained through debt and equity financing.

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

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

	June 30, 2016 (unaudited)	December 31, 2015 (audited)
Oil and Natural Gas:		
Proved properties	\$2,598,757	\$1,734,223
Unproved properties	2,988,945	2,444,608
	5,587,702	4,178,831
Less accumulated depreciation, depletion, and amortization	(7,757)	(5,524)
	\$5,579,945	\$4,173,307

NOTE 4 – RESTRICTED CASH

Restricted cash consists of three bonds totaling \$245,000. The bonds are required in the normal course of business in the oil and gas industry. The two bonds totaling \$45,000 were purchased in November 2013. A third bond totaling \$200,000 was purchased in August 2015 following the acquisition of the Kern Bluff Oil Field. This was a blanket bond, which will cover 50 wells. As such, the Company is in the process of releasing the first two bonds totaling \$45,000.

NOTE 5 – DEPOSITS

The Company had deposits at December 31, 2015 and June 30, 2016 totaling \$9,900.

NOTE 6 – NOTES PAYABLE

Notes payable consists of the following:

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	June 30, 2016 (unaudited)	December 31, 2015 (unaudited)
Note payable to an entity for the financing of insurance premiums, unsecured; 7.75% interest, due April 2017	\$ 58,264	\$ 17,263
Two notes payable to investors, unsecured, 10% interest; due September 30, 2016	\$ 500,000	\$ 500,000
Debt discount for 500,000 warrants issued relating to notes payable	5,938	7,771
Notes Payable - Total	\$ 564,202	\$ 525,034
Notes Payable, Related Party		
Term loan with a related party investor executed July 30, 2015, unsecured, 10% interest; due July 30, 2016	\$ —	\$ 3,500,000
Total – Notes Payable & Notes Payable, Related Party	\$ 564,202	\$ 3,970,869

During the quarter ended March 31, 2016, the Company converted the \$3,500,000 related party note payable with 175,000 of preferred shares valued at \$3,500,000. Interest expense on the note payable was \$91,300.

In March 2014, the Company closed on a \$500,000 bridge loan from two individuals. These notes have a 180 day term and bear interest of 10%. The \$500,000 of notes are due on October 31, 2015. Additionally, the investors received 500,000 warrants to purchase the Company's stock at \$0.34 per share for a term of two years. In December of 2015, the maturity date of this bridge loan was extended until September 30, 2016, in return the exercise price of the warrant was reduced to \$0.20 and the term of the warrants also extended to until September 30, 2016.

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CITADEL EXPLORATION, INC.

Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 7 – STOCKHOLDERS’ EQUITY (DEFICIT)

The Company is authorized to issue 100,000,000 shares of its \$0.001 par value common stock.

In March of 2015, the Company approved the issuance of 1,400,000 common stock shares for the conversion of a \$100,000 promissory note, plus accrued interest of \$2,164 and an additional capital investment of \$107,836, all at \$0.15 per share.

In March of 2015, the Company issued 25,000 shares of common stock to settle the stock payable of \$2,250 recorded as of December 31, 2014.

In July of 2015, the Company issued 6,000,000 shares of common stock and paid \$1,900,000 in cash for the Kern Bluff Oil Field. The Company had paid a \$100,000 deposit on the property in May of 2015, upon execution of a letter of intent (LOI) on the field.

In March of 2016, the Company approved the issuance of up to 250,000 shares of Series A Convertible Participating Preferred Stock. The Company issued 175,000 shares of Series A Convertible Participating Preferred Stock to convert its \$3,500,000 related party note payable to preferred stock. In addition, the Company has sold 21,250 shares of Series A Convertible Participating Preferred Stock for cash in the amount of \$425,000 through March 31, 2016.

In June of 2016, the Company sold 55,000 shares of Series A Convertible Participating Preferred Stock for cash in the amount of \$1,100,000.

NOTE 8 – STOCK OPTION PLAN

Under the Stock Option Plan approved by Board of Directors on September 1, 2012 (the “2012 Stock Option”), the Company issued \$264,494 worth of stock based compensation, or a total of 4,800,000 shares of options through December 31, 2014 expense.

On July 29, 2015 as approved by the Board of Directors, the Company granted 4,700,000 stock options to three members of management and to one member of the Board of Directors. These options vest over a three year period, at \$0.15 per share for a term of seven years. The total fair value of these options at the date of grant was estimated to be \$376,490 and was determined using the Black Scholes option pricing model with an expected life of 7 years, risk free interest rate of 1.872%, dividend yield of 0%, and expected volatility of 333%. During the 3 month period ended September 30, 2015, \$152,198 was recorded as a stock based compensation expense.

The following is a summary of the status of all of the Company's stock options as of March 31, 2016 and changes during the period ended on that date:

	Number of Options	Weighted-Average Exercise Price	Weighted-Average Remaining Life (Years)
Outstanding at June 30, 2016	9,500,000	\$ 0.20	4.76
	—	\$ —	—
Exercised	—	\$ —	—
Cancelled	—	\$ —	—
Outstanding at June 30, 2016	9,500,000	\$ 0.20	4.76
Exercisable at June 30, 2016	5,964,000	\$ 0.21	4.05

Table of Contents**CITADEL EXPLORATION, INC.****Notes to Unaudited Condensed Consolidated Financial Statements****NOTE 9 – WARRANTS**

In September of 2014, the 500,000 warrants issued on November 15, 2012 and 100,000 warrants issued in September 2013 were exercised early at a reduced price of \$0.34 per share.

The following is a summary of the status of all of the Company's stock warrants as of March 31, 2016 and changes during the period ended on that date:

	Number of Warrants	Weighted-Average Exercise Price	Weighted-Average Remaining Life (Years)
Outstanding at March 31, 2016	500,000	\$ 0.20	0.25
Granted	—	\$ 0.00	—
Exercised	—	\$ 0.00	—
Cancelled	—	\$ 0.00	—
Total Outstanding at March 31, 2016	500,000	\$ 0.20	0.25
Exercisable at March 31, 2016	500,000	\$ 0.20	0.25

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FORWARD-LOOKING STATEMENTS

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

- o exploration risks such as drilling unsuccessful wells;
- o our ability to operate profitably;
- o our ability to efficiently and effectively finance our operations;
- o inability to achieve future sales levels or other operating results;
- o inability to raise additional financing for working capital;
- o inability to efficiently manage our operations;
- o inability to hire or retain sufficient qualified operating field personnel;
- o the inability of management to effectively implement our strategies and business plans;
- o the unavailability of funds for capital expenditures and/or general working capital;
- o deterioration in general or regional economic conditions;
- o the fact that our accounting policies and methods are fundamental to how we report our financial condition and results of operations, and they may require management to make estimates about matters that are inherently uncertain;
- o changes in U.S. GAAP or in the legal, regulatory and legislative environments in the markets in which we operate;
- o adverse state or federal legislation or regulation that increases the costs of compliance, or adverse findings by a regulator with respect to existing operations;

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

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

AVAILABLE INFORMATION

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

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

Overview

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

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

Our Operations

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

In December of 2014, Citadel began a work-over on the Yowlumne #2-26 well including installation of a new pump in February of 2015. The well has been producing approximately 20- 25 barrels per day (32 degree API quality) since the beginning of March. In June the well's pump had a mechanical issue, the company performed well maintenance in August returning the well to its previous production level. During December of 2015, extremely cold weather forced the shut-down of the #2-26 well. Citadel plans to return the well to production in the fourth quarter of 2016. Citadel is in the final stages of the CEQA process to permit two additional exploration wells on the Yowlumne acreage. Recent regulatory changes, including SB4 the State of California's bill on fracking have delayed the final approval of our CEQA application. As such we do not expect to have these prospects permitted until the end of 2016, at which time we will determine when to drill. Both of these exploration wells will be targeting the Stephens Sands at a depth of 12,000 to 15,000 feet. Citadel currently has a 75% working interest in these exploration prospects and is the operator.

On July 31, 2015 Citadel acquired approximately 1,100 acres of leases, production facilities and equipment that encompassed the Kern Bluff Oil Field. As consideration for this acquisition Citadel issued 6,000,000 shares of common stock and paid \$2,000,000 in cash. The transaction was financed via a \$3,500,000 one year term loan from

Cibolo Creek Partners, of Midland Texas. In March of 2016, Cibolo Creek Partners converted the \$3,500,000 term loan into Series A Participating Preferred Stock.

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

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In June of 2016, Citadel completed its facility upgrades; the new facilities have production capacity of 500-700 BOPD. Citadel began drilling three wells in June and returned to production 9 idle wells. Production from the new wells continues to increase as the wells clean up. As of August 15, 2016 the Company was producing approximately 50 barrels of oil per day. The Company is currently working on purchasing and installing a steam generator, to begin cyclic steaming operations in the 4th quarter of 2016.

Going Concern

The condensed consolidated financial statements included in this filing have been prepared in conformity with generally accepted accounting principles that contemplate the continuance of the Company as a going concern, which contemplates the realization of assets and liquidation of liabilities in the normal course of business. However, the Company is in the exploration stage and, accordingly, has not generated revenues from operations. As shown on the accompanying condensed consolidated financial statements, the Company has incurred an accumulated deficit in the amount of \$7,641,125 as of June 30, 2016. These conditions raise substantial doubt about the Company's ability to continue as a going concern.

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

RESULTS OF OPERATIONS

Results of Operations for the Six Months Ended June 30, 2016 and June 30, 2015

During the six month period ended June 30, 2016 we generated \$26,762 from the sale of oil. During the six month period ended June 30, 2015 we generated \$60,141 from the sale of oil.

Operating expenses totaled \$650,250 during the six month period ended June 30, 2016 which was an increase over the period ended June 30, 2015. Operating expenses consisted of lease operating expense, general and administrative costs, amortization and depreciation, professional fees, and executive compensation. The increase consisted primarily of an increase in lease operating expenses and professional fees, while general and administrative costs decreased. During the period ended June 30, 2015 the Company's operating expense totaled \$563,961.

General and administrative fees decreased from \$187,714 to \$131,057 from the six month period ended June 30, 2015 to the six month period ended June 30, 2016. This decrease was primarily due to insurance, marketing and meals and entertainment expenses.

Professional fees increased from \$18,236 to \$138,259 from the six month period ended June 30, 2015 to the six month period ended June 30, 2016. The increase was primarily due to services provided to the Company for accounting, consulting and legal.

Executive compensation decreased from \$324,177 to \$261,699 from the six month period ended June 30, 2015 to the six month period ended June 30, 2016. The decrease was primarily due to the stock options that fully vested in 2015.

Liquidity and Capital Resources

The Company has established a capital budget for 2016 of \$4,000,000 to complete facility remediation, return to production up to 20 wells and drill up to 5 vertical wells and 1 horizontal well. Given the current state of depressed oil prices, the Company's ability to complete this capital budget will be highly dependent on higher oil prices and access to capital.

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As of June 30, 2016, the Company had \$136,178 of current assets; of this amount \$38,425 was cash. The following table provides detailed information about the net cash flow for the quarters ended June 30, 2016 and June 30, 2015 as presented in this quarterly report. To date, we have financed our operations through the issuance of stock and borrowings from related parties and an unrelated third party.

The following table sets forth a summary of our cash flows for the three months ended June 30, 2016 and 2015:

	Six Months Ended	
	June 30,	
	2016	2015
Net cash used in operating activities	\$(161,593)	\$(363,499)
Net cash used in investing activities	(1,408,873)	(176,762)
Net cash provided by financing activities	1,462,336	297,606
Net change in cash	(108,130)	(242,655)
Cash, beginning of period	146,555	270,298
Cash, end of period	\$38,425	\$27,641

Operating activities

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

Investing activities

The net cash used in investing activities consisted of drilling expenses and facility upgrades on oil and gas properties of \$1,408,873 on the Company's properties.

Financing activities

The net cash provided by financing activities consisted of proceeds from the preferred stock offering, net of offering costs, totaling \$1,425,000, a note payable totaling 68,736 and note repayments totaling \$31,400.

As of March 31, 2016, we continue to use traditional and/or debt financing as well as through the issuance of stock to provide the capital we need to run our business.

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

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

Contractual Obligations

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

Off-Balance Sheet Arrangements

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

Operation Plan

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

We expect to achieve these results by:

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

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

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

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

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

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Item 3. Quantitative and Qualitative Disclosure About Market Risk

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

Item 4T. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control Over Financial Reporting

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

Limitations on Effectiveness of Controls and Procedures

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

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PART II—OTHER INFORMATION

Item 1. Legal Proceedings.

From time to time, we may become involved in various lawsuits and legal proceedings which arise in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these or other matters may arise from time to time that may harm our business. We received notice on or about July 10, 2013 that the Center for Biological Diversity (“CBD”) had filed a law suit against the County of San Benito regarding the approval of Project Indian which is described more fully, above, as the “Case”. The Board of Supervisors voted 5-0 in favor of our application to drill 15 exploration wells on our Project Indian lease. The Court approved the petition in a judgment entered on September 4, 2014, and ruled that Citadel was required to obtain an environmental impact report before commencing Project Indian. Thereafter, the Court awarded the petitioner \$347,969 as attorney’s fees and costs against the County of San Benito and Citadel, jointly and severally. The Company has requested a dismissal of its appeal of this decision which was granted as the Court required the Company to post a bond in which it was unable to qualify for. In October of 2015, the company paid \$92,693 to the Center for Biological Diversity for a share of the attorney’s fees and costs outstanding which satisfied the judgment for attorney’s fees and costs in full. Currently, the County of San Benito and Company are engaged in litigation concerning the responsibility for the full-amount of the judgment for attorney’s fees and costs.

On November 4, 2014 voters in the County of San Benito passed Measure J which bans hydraulic fracturing and other stimulation techniques defined as “high intensity petroleum operations” by the Measure, including steam injection. The initiative was passed by a count of 8,034 to 5,605. In advance of the initiative passing, the County preemptively passed an ordinance allowing for exemptions from the application of the Measure in the event the Measure would result in a taking. A regulatory taking is a situation in which a government regulation limits the uses of private property to such a degree that the regulation effectively deprives the property owners of economically reasonable use or value of their property right to such an extent that it deprives them of utility or value of that property right, even though the regulation does not formally divest them of title to it. Accordingly, Citadel Exploration Inc. will provide the County of San Benito the ability to compensate the company for the diminished value at the Indian Oil Field based on the reasonable Unrisked Resource Potential the property would ultimately yield, or allow Citadel to proceed with full field development and steam injection under the exemption ordinance. At this time Citadel has reserved its rights, with respect to the Indian Oil Field, including claims for inverse condemnation.

Item 1A. Risk Factors.

Our significant business risks are described in Item 1A. to Part I of Form 10-K for the year ended December 31, 2015 (filed April 15, 2016) to which reference is made herein.

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

Stock Issuances pursuant to Subscription Agreements

In December 2014, the Company approved the issuance of 500,000 common stock shares for engineering, legal, accounting and marketing services performed in the fourth quarter of 2014.

In March of 2015, the Company approved the issuance of 1,400,000 common stock shares and issued 25,000 shares recorded as a stock payable at December 31, 2014, for the conversion of a \$100,000 promissory note, plus accrued interest of \$2,164 and an additional capital investment of \$107,835, all at \$0.15 per share.

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In July of 2015, the Company approved the issuance of 6,000,000 common stock shares as partial consideration for the purchase of the Kern Bluff Oil Field.

In March of 2016, the Company approved the issuance of up to 250,000 Series A Participating Preferred Stock. The Series A Participating Preferred Stock has a 3 year term, with a 10% coupon. Each share of Series A converts into 100 shares of the Company's common stock, equaling a conversion price of \$0.20 a share. Additionally the Series A Participating Preferred Stock has a 2% overriding royalty (ORRI) on the Kern Bluff Oil Field, until conversion, at which time the ORRI is reduced to 1% in perpetuity. The company issued 38,750 shares to investors for cash proceeds of \$775,000. Additionally the Company converted the \$3,500,000 term loan with Cibolo Creek Partners into 175,000 shares of Series A Participating Preferred Stock. Cibolo Creek also subscribed for an additional 5,000 shares of Series A Participating Preferred Stock for cash proceeds of \$100,000.

In June of 2016, the Company issued 32,500 shares to investors for cash proceeds of \$650,000.

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

Option Grants

Our option grants are described in Form 10-K for the year ended December 31, 2015 (filed April 15, 2016) to which reference is made herein.

Subsequent Stock Issuances

None.

Issuer Purchases of Equity Securities

We did not repurchase any of our equity securities from the time of our inception on November 6, 2006 through the period ended June 30, 2016.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

2012 Stock Incentive Plan

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

Our employment agreements with executive officers are described in Form 10-K for the year ended December 31, 2015 (filed April 15, 2016) to which reference is made herein.

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Item 6. Exhibits.

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

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

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SIGNATURE

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

CITADEL EXPLORATION, INC.

Date: August 15, 2016

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