

CHENIERE ENERGY INC  
Form 10-K/A  
July 20, 2004  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**Form 10-K/A**  
**Amendment No. 2**

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x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2003

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 001-16383

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**CHENIERE ENERGY, INC.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**95-4352386**  
(I.R.S. Employer  
Identification No.)

**717 Texas Avenue, Suite 3100**

**Houston, Texas**  
(Address of principal executive offices)

**77002**  
(Zip code)

**Registrant's telephone number, including area code: (713) 659-1361**

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**Securities registered pursuant to Section 12(b) of the Act:**

**None**

**Securities registered pursuant to Section 12(g) of the Act:**

**Common Stock, \$ 0.003 par value**  
(Title of Class)

**American Stock Exchange**  
(Name of each exchange on which registered)

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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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value of the registrant's Common Stock held by non-affiliates of the registrant was approximately \$66,180,000 as of June 30, 2003.

18,659,994 shares of the registrant's Common Stock were outstanding as of February 29, 2004.

Documents incorporated by reference: The definitive proxy statement for the registrant's Annual Meeting of Stockholders (to be filed within 120 days of the close of the registrant's fiscal year) is incorporated by reference into Part III.

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**EXPLANATORY NOTE**

Cheniere Energy, Inc. has filed certain registration statements which have not yet been declared effective by the Securities and Exchange Commission and which will require consents from accountants in order to become effective; we may amend registration statements that have been filed, which could require additional consents from accountants; or we may file additional registration statements which would require further consents from accountants. We believe that the process of obtaining such consents will be more efficient and cost effective by having our current independent accountants, UHY Mann Frankfort Stein & Lipp CPAs, LLP ( UMFS&L ) report on our consolidated balance sheet as of December 31, 2003 and 2002, and our statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2003. Our statements of operations, stockholders' equity and cash flows for the year ended December 31, 2001 (the

Cheniere 2001 Financial Statements ) had previously been audited by PricewaterhouseCoopers LLP. As a result, we engaged UMFS&L to reaudit the Cheniere 2001 Financial Statements. The reaudit of the Cheniere 2001 Financial Statements did not result in any revision to these financial statements, as reported in our Annual Report on Form 10-K for the fiscal year ended December 31, 2003, as originally filed on March 25, 2004 and as amended on May 26, 2004 (the 2003 10-K ).

During 2001 and 2002, we accounted for our investment in Gryphon Exploration Company ( Gryphon ) on the equity basis of accounting and included Gryphon's balance sheet as of December 31, 2002 and its statements of operations, stockholders' equity and cash flows for each of the two years in the period ended December 31, 2002 as part of our 2003 10-K. Gryphon also engaged its current independent accountants, KPMG LLP, to reaudit its consolidated statements of operations, stockholders' equity and cash flows for the year ended December 31, 2001 (the

Gryphon 2001 Financial Statements ). The Gryphon 2001 Financial Statements had also previously been audited by PricewaterhouseCoopers LLP.

This Amendment No. 2 to our 2003 10-K is being filed in order to (i) replace the Report of Independent Accountants signed by PricewaterhouseCoopers LLP and dated March 29, 2002 relating to the Cheniere 2001 Financial Statements with the Report of Independent Registered Public Accounting Firm signed by UMFS&L and dated July 14, 2004, (ii) replace the Report of Independent Accountants signed by PricewaterhouseCoopers LLP and dated March 29, 2002 relating to the Gryphon 2001 Financial Statements with the Report of Independent Registered Public Accounting Firm signed by KPMG LLP and dated July 12, 2004, (iii) provide the consent of UMFS&L to incorporate by reference its updated report dated July 14, 2004 into certain of the Company's registration statements and (iv) provide the consent of KPMG LLP to incorporate by reference its report relating to the Gryphon 2001 Financial Statements into certain of the Company's registration statements.

**Index to Amendment No. 2**

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CHENIERE ENERGY, INC. AND SUBSIDIARIES

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All schedules are omitted because they are not applicable or the required information is shown in the consolidated financial statements or notes thereto.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and

Stockholders of Cheniere Energy, Inc:

We have audited the consolidated balance sheets of Cheniere Energy, Inc. and subsidiaries (the Company) as of December 31, 2003 and 2002, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the financial statements of Freeport LNG Development, L.P. (Freeport LNG), an investment which, as discussed in note 7 to the consolidated financial statements, is accounted for by the equity method of accounting. The investment in Freeport LNG was zero as of December 31, 2003 and 2002, and the equity in its net loss was \$4,471,529, zero and zero, respectively, for each of the three years in the period ended December 31, 2003. We also did not audit the financial statements of Gryphon Exploration Company (Gryphon), an investment which, as discussed in Note 6 to the consolidated financial statements, has been, until January 1, 2003, accounted for by the equity method of accounting. The investment in Gryphon was zero as of December 31, 2003 and 2002, and the equity in its net loss was zero, \$2,184,847 and \$2,974,191, respectively, for each of the three years in the period ended December 31, 2003. The financial statements of Freeport LNG and Gryphon were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for Freeport LNG and Gryphon, are based solely on the reports of the other auditors.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Cheniere Energy, Inc. and subsidiaries at December 31, 2003 and 2002, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States.

**UHY MANN FRANKFORT STEIN & LIPP CPAs, LLP**

Houston, Texas

July 14, 2004

**Table of Contents****CHENIERE ENERGY, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEET**

|   | <b>December 31,</b>  |                      |
|---|----------------------|----------------------|
|   | <b>2003</b>          | <b>2002</b>          |
| <b><u>ASSETS</u></b>  |                      |                      |
| <b>CURRENT ASSETS</b>   |                      |                      |
| Cash and Cash Equivalents   | \$ 1,257,693         | \$ 590,039           |
| Accounts Receivable   |                      |                      |
| Affiliates  | 1,000,000            |                      |
| Other   | 1,828,065            | 1,137,682            |
| Prepaid Expenses  | 401,594              | 121,099              |
| <b>Total Current Assets</b>   | <b>4,487,352</b>     | <b>1,848,820</b>     |
| <b>OIL AND GAS PROPERTIES, full cost method</b>   |                      |                      |
| Proved Properties, net  | 1,087,152            | 842,882              |
| Unproved Properties, not subject to amortization  | 18,047,802           | 16,751,347           |
| <b>Total Oil and Gas Properties</b>   | <b>19,134,954</b>    | <b>17,594,229</b>    |
| LNG SITE COSTS  | 310,500              | 1,400,000            |
| FIXED ASSETS, net   | 578,281              | 216,341              |
| <b>INVESTMENT IN UNCONSOLIDATED AFFILIATE</b>   |                      |                      |
| <b>INVESTMENT IN LIMITED PARTNERSHIP</b>  |                      |                      |
| INTANGIBLE LNG ASSETS   | 79,670               |                      |
| <b>Total Assets</b>   | <b>\$ 24,590,757</b> | <b>\$ 21,059,390</b> |
| <b><u>LIABILITIES AND STOCKHOLDERS' EQUITY</u></b>  |                      |                      |
| <b>CURRENT LIABILITIES</b>  |                      |                      |
| Accounts Payable  | \$ 1,984,314         | \$ 1,828,267         |
| Accrued Liabilities   | 1,347,512            | 683,788              |
| Note Payable  | 1,000,000            | 750,000              |
| <b>Total Current Liabilities</b>  | <b>4,331,826</b>     | <b>3,262,055</b>     |
| DEFERRED REVENUE  | 1,000,000            |                      |
| MINORITY INTEREST   | 120,032              |                      |
| <b>COMMITMENTS AND CONTINGENCIES</b>  |                      |                      |
| <b>STOCKHOLDERS' EQUITY</b>   |                      |                      |
| Preferred Stock, \$.0001 par value  |                      |                      |
| Authorized: 5,000,000 shares  |                      |                      |
| Issued and Outstanding: none  |                      |                      |
| Common Stock, \$.003 par value  |                      |                      |
| Authorized: 40,000,000 shares   |                      |                      |
| Issued and Outstanding: 16,488,187 shares at December 31, 2003 and 13,297,393 shares at December 31, 2002 | 49,465               | 39,892               |
| Additional Paid-in-Capital  | 48,034,244           | 41,414,236           |
| Accumulated Deficit   | (28,944,810)         | (23,656,793)         |

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|   |               |               |
|---|---------------|---------------|
| Total Stockholders Equity                 | 19,138,899    | 17,797,335    |
| Total Liabilities and Stockholders Equity | \$ 24,590,757 | \$ 21,059,390 |

The accompanying notes are an integral part of these financial statements.



**Table of Contents****CHENIERE ENERGY, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENT OF OPERATIONS**

|  | Year Ended December 31, |                       |                        |
|--|-------------------------|-----------------------|------------------------|
|  | 2003                    | 2002                  | 2001                   |
| <b>Revenues</b>  |                         |                       |                        |
| Oil and Gas Sales  | \$ 657,467              | \$ 239,055            | \$ 2,372,632           |
| <b>Total Revenues</b>  | <b>657,467</b>          | <b>239,055</b>        | <b>2,372,632</b>       |
| <b>Operating Costs and Expenses</b>                                    |                         |                       |                        |
| Production Costs   |                         | 90,038                | 420,242                |
| Depreciation, Depletion and Amortization                               | 428,680                 | 368,562               | 1,243,828              |
| Ceiling Test Write-down  |                         |                       | 5,126,248              |
| General and Administrative Expenses                                    |                         |                       |                        |
| LNG Terminal Development   | 6,704,538               | 1,556,782             | 1,788,419              |
| Other  | 2,542,399               | 1,918,580             | 2,503,544              |
| <b>General and Administrative Expenses</b>                             | <b>9,246,937</b>        | <b>3,475,362</b>      | <b>4,291,963</b>       |
| <b>Total Operating Costs and Expenses</b>                              | <b>9,675,617</b>        | <b>3,933,962</b>      | <b>11,082,281</b>      |
| <b>Loss from Operations</b>  | <b>(9,018,150)</b>      | <b>(3,694,907)</b>    | <b>(8,709,649)</b>     |
| Equity in Net Loss of Unconsolidated Affiliate                         |                         | (2,184,847)           | (2,974,191)            |
| Equity in Net Loss of Limited Partnership                              | (4,471,529)             |                       |                        |
| Gain on Sale of Proved Oil and Gas Properties                          |                         | 340,257               |                        |
| Gain on Sale of LNG Assets   | 4,760,000               |                       |                        |
| Gain on Sale of Limited Partnership Interest                           | 423,454                 |                       |                        |
| Loss on Early Extinguishment of Debt                                   |                         | (100,544)             |                        |
| Interest Income  | 2,740                   | 7,733                 | 18,578                 |
| <b>Loss Before Income Taxes and Minority Interest</b>                  | <b>(8,303,485)</b>      | <b>(5,632,308)</b>    | <b>(11,665,262)</b>    |
| Provision for Income Taxes   |                         |                       |                        |
| <b>Loss Before Minority Interest</b>                                   | <b>(8,303,485)</b>      | <b>(5,632,308)</b>    |                        |
| Minority Interest  | 3,015,468               |                       |                        |
| <b>Net Loss</b>  | <b>\$ (5,288,017)</b>   | <b>\$ (5,632,308)</b> | <b>\$ (11,665,262)</b> |
| <b>Net Loss Per Share Basic and Diluted</b>                            | <b>\$ (0.36)</b>        | <b>\$ (0.42)</b>      | <b>\$ (0.89)</b>       |
| <b>Weighted Average Number of Shares Outstanding Basic and Diluted</b> | <b>14,771,700</b>       | <b>13,297,393</b>     | <b>13,035,256</b>      |

The accompanying notes are an integral part of these financial statements.



**Table of Contents****CHENIERE ENERGY, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY**

|                               | Common Stock |           | Additional<br>Paid-In<br>Capital | Accumulated<br>Deficit | Total<br>Stockholders<br>Equity |
|-------------------------------|--------------|-----------|----------------------------------|------------------------|---------------------------------|
|                               | Shares       | Amount    |                                  |                        |                                 |
| Balance December 31, 2000     | 12,547,393   | \$ 37,642 | \$ 39,382,789                    | \$ (6,359,223)         | \$ 33,061,208                   |
| Issuances of Stock            | 750,000      | 2,250     | 1,647,750                        |                        | 1,650,000                       |
| Issuances of Warrants         |              |           | 110,000                          |                        | 110,000                         |
| Expenses Related to Offerings |              |           | (6,671)                          |                        | (6,671)                         |
| Net Loss                      |              |           |                                  | (11,665,262)           | (11,665,262)                    |
| Balance December 31, 2001     | 13,297,393   | \$ 39,892 | \$ 41,133,868                    | \$ (18,024,485)        | \$ 23,149,275                   |
| Issuances of Warrants         |              |           | 280,368                          |                        | 280,368                         |
| Net Loss                      |              |           |                                  | (5,632,308)            | (5,632,308)                     |
| Balance December 31, 2002     | 13,297,393   | \$ 39,892 | \$ 41,414,236                    | \$ (23,656,793)        | \$ 17,797,335                   |
| Issuances of Stock            | 3,190,794    | 9,573     | 5,732,915                        |                        | 5,742,488                       |
| Issuances of Warrants         |              |           | 945,049                          |                        | 945,049                         |
| Expenses Related to Offerings |              |           | (57,956)                         |                        | (57,956)                        |
| Net Loss                      |              |           |                                  | (5,288,017)            | (5,288,017)                     |
| Balance December 31, 2003     | 16,488,187   | \$ 49,465 | \$ 48,034,244                    | \$ (28,944,810)        | \$ 19,138,899                   |

The accompanying notes are an integral part of these financial statements.

**Table of Contents****CHENIERE ENERGY, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENT OF CASH FLOWS**

|   | Year Ended December 31, |                    |                    |
|---|-------------------------|--------------------|--------------------|
|   | 2003                    | 2002               | 2001               |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                |                         |                    |                    |
| Net Loss  | \$ (5,288,017)          | \$ (5,632,308)     | \$ (11,665,262)    |
| Adjustments to Reconcile Net Loss to Net Cash Used In Operating Activities: |                         |                    |                    |
| Depreciation, Depletion and Amortization                                    | 428,680                 | 368,562            | 1,243,828          |
| Ceiling Test Write-down   |                         |                    | 5,126,248          |
| Non-Cash Expense  | (3,636)                 | (32,649)           | 380,000            |
| Gain on Sale of Proved Oil and Gas Properties                               |                         | (340,257)          |                    |
| Loss on Early Extinguishment of Debt  |                         | 100,544            |                    |
| Equity in Net Loss of Unconsolidated Affiliate                              |                         | 2,184,847          | 2,974,191          |
| Equity in Net Loss of Limited Partnership                                   | 4,471,529               |                    |                    |
| Gain on Sale of LNG Assets  | (4,760,000)             |                    |                    |
| Gain on Sale of Limited Partnership Interest                                | (423,454)               |                    |                    |
| Minority Interest   | (3,015,468)             |                    |                    |
| Changes in Operating Assets and Liabilities                                 |                         |                    |                    |
| Other Accounts Receivable   | 229,747                 | (752,648)          | 591,672            |
| Prepaid Expenses  | (482,428)               | (27,786)           | 14,818             |
| Accounts Payable and Accrued Liabilities                                    | 1,284,183               | 1,367,370          | (877,772)          |
| <b>NET CASH USED IN OPERATING ACTIVITIES</b>                                | <b>(7,558,864)</b>      | <b>(2,764,325)</b> | <b>(2,212,277)</b> |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                |                         |                    |                    |
| Purchases of Fixed Assets   | (340,837)               | (14,506)           | (407,817)          |
| Oil and Gas Property Additions  | (2,514,357)             | (1,430,472)        | (4,343,705)        |
| Net Proceeds from Sale of Proved Oil and Gas Properties                     |                         | 2,235,365          |                    |
| Sale of Interest in Oil and Gas Prospects                                   | 391,350                 | 628,259            | 2,039,429          |
| Sale of Oil and Gas Seismic Data  |                         | 825,000            | 3,353,197          |
| LNG Site Costs  |                         | (250,000)          | (200,000)          |
| Purchase of Intangible LNG Assets   | (79,670)                |                    |                    |
| Sale of LNG Assets  | 1,873,000               |                    |                    |
| Sale of Limited Partnership Interest  | 700,000                 |                    |                    |
| <b>NET CASH PROVIDED BY INVESTING ACTIVITIES</b>                            | <b>29,486</b>           | <b>1,993,646</b>   | <b>441,104</b>     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                |                         |                    |                    |
| Proceeds from Issuances of Notes Payable                                    | 1,225,000               | 1,250,000          |                    |
| Repayment of Note Payable   | (225,000)               | (500,000)          |                    |
| Sale of Common Stock  | 4,429,988               |                    | 500,000            |
| Offering Costs  | (57,956)                |                    | (6,671)            |
| Partnership Contributions by Minority Owner                                 | 2,825,000               |                    |                    |
| <b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>                            | <b>8,197,032</b>        | <b>750,000</b>     | <b>493,329</b>     |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                 | <b>667,654</b>          | <b>(20,679)</b>    | <b>(1,277,844)</b> |

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|   |                     |                   |                   |
|---|---------------------|-------------------|-------------------|
| CASH AND CASH EQUIVALENTS BEGINNING OF YEAR | <u>590,039</u>      | <u>610,718</u>    | <u>1,888,562</u>  |
| CASH AND CASH EQUIVALENTS END OF YEAR       | <u>\$ 1,257,693</u> | <u>\$ 590,039</u> | <u>\$ 610,718</u> |

The accompanying notes are an integral part of these financial statements.

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**CHENIERE ENERGY, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 ORGANIZATION AND NATURE OF OPERATIONS**

Cheniere Energy, Inc., a Delaware corporation, is a Houston-based company engaged primarily in the development of a liquefied natural gas ( LNG ) receiving terminal business and related LNG business opportunities centered on the U.S. Gulf Coast. The terms Cheniere and Company refer to Cheniere Energy, Inc. and its subsidiaries. Cheniere is also engaged in oil and gas exploration, development and exploitation activities in the Gulf of Mexico.

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation**

The consolidated financial statements include the accounts of Cheniere Energy, Inc. and its majority-owned subsidiaries. Cheniere also holds ownership interests in entities that are accounted for under the equity method and cost method of accounting. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain items in the prior year financial statements have been reclassified to conform with the 2003 presentation.

**LNG Activities**

The Company has been in the preliminary stage of developing LNG receiving terminals. Substantially all costs related thereto have been expensed when incurred. Land costs associated with LNG terminal sites are capitalized. Costs of certain permits are capitalized as intangible LNG assets. Cheniere has also incurred costs related to options to purchase or lease land that may be used for potential LNG terminal sites.

**Oil and Gas Properties**

The Company follows the full cost method of accounting for its oil and gas properties. Under this method, all productive and nonproductive exploration and development costs incurred for the purpose of finding oil and gas reserves are capitalized. Such capitalized costs include lease acquisition, geological and geophysical work, delay rentals, drilling, completing and equipping oil and gas wells, together with internal costs directly attributable to property acquisition, exploration and development activities. Interest is capitalized on oil and gas properties not subject to amortization and in the process of development. The Company capitalized interest totaling \$41,107, (\$42,261) and \$165,813 and general and administrative expenses, net of reimbursements, totaling \$976,000, \$829,000 and \$782,000 for the years 2003, 2002 and 2001, respectively. Capitalized interest for 2002 was negative due to a refund of interest that was paid in 2001.

The costs of the Company's oil and gas properties, including the estimated future costs to develop proved reserves, are depreciated using a composite units-of-production rate based on estimates of proved reserves. Investments in unproved properties and major development projects are not amortized until proved reserves associated with the projects can be determined or until impairment occurs. If the results of an assessment indicate that the properties are impaired, then the amount of the impairment is added to the capitalized costs to be amortized. Net capitalized costs are limited to a capitalization ceiling, calculated on a quarterly basis as the aggregate of the present value, discounted at 10%, of estimated future net revenues from proved reserves, based on current economic and operating conditions, plus the lower of cost or fair market value of unproved properties, less related income tax effects.

The Company's allocation of seismic exploration costs between proved and unproved properties involves an estimate of the total reserves to be discovered in the Company's exploration program. This estimate includes a number of assumptions that Cheniere has factored into a four-year plan. Such factors include an estimate of the number of exploration prospects generated, prospect reserve potential, success ratios and ownership interests. The Company transfers unproved properties to proved properties based on a ratio of proved reserves discovered at a point in time to the estimate of total reserves to be discovered in Cheniere's exploration program. It is reasonably possible, based on the results obtained from future drilling and prospect generation, that revisions to this estimate could affect the Company's capitalization ceiling.

Sales of proved and unproved properties are accounted for as adjustments of capitalized costs with no gain or loss recognized, unless such adjustments would significantly alter the relationship between capitalized costs and proved oil and gas reserves.

In July 2003, an issue was brought before the Financial Accounting Standards Board (FASB) regarding whether or not contract-based oil and gas mineral rights held by lease or contract ( mineral rights ) should be recorded or disclosed as intangible assets. The issue presents a view that these mineral rights are intangible assets as defined in Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations, and, therefore, should be classified separately on the balance sheet as intangible assets. SFAS No. 141 and SFAS No. 142, Goodwill and Other Intangible Assets, became effective for transactions subsequent to June 30, 2001, with

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**CHENIERE ENERGY, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the disclosure requirements of SFAS No. 142 required as of January 1, 2002. SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for using the purchase method and that intangible assets be disaggregated and reported separately from goodwill. SFAS No. 142 established new accounting guidelines for both finite lived intangible assets and indefinite lived intangible assets. Under the statement, intangible assets should be separately reported on the face of the balance sheet and accompanied by disclosure in the notes to financial statements. SFAS No. 142 does not apply to accounting utilized by the oil and gas industry as prescribed by SFAS No. 19, and is silent about whether or not its disclosure provisions apply to oil and gas companies. The Emerging Issues Task Force (EITF) has added the treatment of oil and gas mineral rights to an upcoming agenda, which may result in a change in how Cheniere classifies these assets.

Should such a change be required, the amounts related to business combinations and major asset purchases that would be classified as intangible undeveloped mineral interest are immaterial as of December 31, 2003 and December 31, 2002. The amounts related to business combinations and major asset purchases that would be classified as intangible developed mineral interest are also immaterial as of December 31, 2003 and December 31, 2002.

**Revenue Recognition**

Revenues from the sale of oil and gas production are recognized upon passage of title, net of royalty interests. When sales volumes differ from the Company's entitled share, an underproduced or overproduced imbalance occurs. To the extent an overproduced imbalance exceeds the Company's share of the remaining estimated proved natural gas reserves for a given property, the Company records a liability. At December 31, 2003 and 2002, the Company had no gas imbalances.

**Fixed Assets**

Fixed assets are recorded at cost. Repairs and maintenance costs are charged to operations as incurred. Depreciation is computed using the straight-line method over their estimated useful lives, which range from two to five years. Upon retirement or other disposition of fixed assets, the cost and related accumulated depreciation is removed from the accounts and the resulting gains or losses are recorded.

**Offering Costs**

Offering costs consist primarily of placement fees, professional fees and printing costs. These costs are charged against the related proceeds from the sale of common stock in the periods in which they occur or charged to expense in the event of a terminated offering.



## Income Taxes

Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes on temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled as prescribed in SFAS No. 109, *Accounting for Income Taxes*. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the current period's provision for income taxes. A valuation allowance is provided for deferred tax assets if it is more likely than not that such asset will not be realizable.

## Stock-Based Compensation

SFAS No. 123, *Accounting for Stock-Based Compensation*, encourages, but does not require, companies to record compensation cost for stock-based employee compensation plans at fair value. In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure - an amendment of FASB Statement No. 123*, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. The statement also amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based compensation and the effect of the method used on reported results.

The Company has chosen to continue to account for stock-based compensation issued to employees using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Accordingly, compensation cost for stock options is measured as the excess, if any, of the quoted market price of the Company's stock at the date of the grant over the amount an employee must pay to acquire the stock. The Company grants options at or above the market price of its common stock at the date of each grant.

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## CHENIERE ENERGY, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The fair value of options is calculated using the Black-Scholes option-pricing model. Had the Company adopted the fair value method of accounting for stock based compensation, compensation expense would have been higher, and net loss and net loss attributable to common shareholders would have increased for the periods presented. No change in cash flows would occur. The effects of applying SFAS No. 123 in this pro forma disclosure are not indicative of future amounts.

|  | Year Ended December 31, |                |                 |
|--|-------------------------|----------------|-----------------|
|  | 2003                    | 2002           | 2001            |
| Net loss as reported   | \$ (5,288,017)          | \$ (5,632,308) | \$ (11,665,262) |
| Deduct:  |                         |                |                 |
| Total stock based employee compensation expense determined under fair value based method for all awards, net of related income tax | (966,795)               | (607,766)      | (427,575)       |
| Pro forma net loss   | \$ (6,254,812)          | \$ (6,240,074) | \$ (12,092,837) |
| Net Loss Per Share   |                         |                |                 |
| Basic as reported  | \$ (0.36)               | \$ (0.42)      | \$ (0.89)       |
| Basic pro forma  | (0.42)                  | (0.47)         | (0.93)          |
| Diluted as reported  | (0.36)                  | (0.42)         | (0.89)          |
| Diluted pro forma  | (0.42)                  | (0.47)         | (0.93)          |

The weighted average fair value of warrants and options granted as employee compensation during 2003, 2002 and 2001 was \$1.44, \$1.20 and \$0.76 respectively. The fair values were determined using the Black-Scholes option-pricing model with the following weighted average assumptions, and a forfeiture rate that is assumed to be negligible:

|                             | Year Ended December 31, |           |           |
|-----------------------------|-------------------------|-----------|-----------|
|                             | 2003                    | 2002      | 2001      |
| Dividend yield              | 0.0%                    | 0.0%      | 0.0%      |
| Weighted average volatility | 107.5%                  | 107.8%    | 84.3%     |
| Risk-free interest rate     | 3.0%                    | 2.9%      | 3.5%      |
| Expected lives of options   | 4.0 years               | 4.0 years | 4.0 years |

**Earnings (Loss) Per Share**

Earnings (loss) per share (EPS) is computed in accordance with the requirements of SFAS No. 128, *Earnings Per Share*. Basic EPS excludes dilution and is computed by dividing net income (loss) by the weighted average number of shares outstanding during the period. Diluted EPS reflects potential dilution and is computed by dividing net income by the weighted average number of common shares outstanding during the

period increased by the number of additional common shares that would have been outstanding if the potential common shares had been issued. Potential dilutive common stock equivalents include stock options from employee benefit plans and warrants to purchase common stock. Basic and diluted EPS for all periods presented are the same since the effect of the Company's options and warrants is antidilutive to its net loss per share under SFAS No. 128. Stock options and warrants representing securities that could potentially dilute basic EPS in the future that were not included in the fully diluted computation because they would have been anti-dilutive for the years 2003, 2002 and 2001 were 3,259,583, 4,577,132 and 4,591,399, respectively. No adjustments were made to reported net loss in the computation of EPS.

#### **Cash Equivalents**

The Company classifies all investments with original maturities of three months or less as cash equivalents.

#### **Fair Value of Financial Instruments**

The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and notes payable approximate fair value because of the short maturity of those instruments.

#### **Commodity Price Risk**

The Company produces and sells natural gas, crude oil and condensate. As a result, the Company's financial results can be affected as these commodity prices fluctuate widely in response to changing market forces. The Company has not entered into any hedging transactions. The Company's market risk with respect to its variable-rate, short-term note payable is considered to be immaterial due to the short-term nature of this instrument.

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**CHENIERE ENERGY, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Concentration of Credit Risk**

All of the Company's revenues are attributable to overriding royalty interests in properties operated by two companies. These companies sell Cheniere's royalty share of production for Cheniere, pay the associated severance taxes, and remit the balance to Cheniere. The Company's products are commodities and have a readily available market for sale.

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires that the Company make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. The most significant estimate pertains to proved oil and gas reserve volumes. Actual results could differ from those estimates.

**New Accounting Pronouncements**

In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities*, and subsequently revised the Interpretation in December 2003 (FIN 46R). This Interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, addresses consolidation by business enterprises of variable interest entities, which have certain characteristics. As revised, FIN 46R is now generally effective for financial statements for interim or annual periods ending on or after March 15, 2004. We have not identified any variable interest entities. In the event a variable interest entity is identified, we do not expect the requirements of FIN 46R to have a material impact on our consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. An issuer is required to classify a financial instrument that is within the scope of this statement as a liability (or an asset in some circumstances). SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We adopted the standard on July 1, 2003, and the adoption did not have a material impact on our consolidated financial statements.

**NOTE 3 ACCRUED LIABILITIES**

Accrued liabilities consist of the following:

|                                    | December 31,        |                   |
|------------------------------------|---------------------|-------------------|
|                                    | 2003                | 2002              |
| Taxes other than income            | \$ 36,986           | \$ 42,611         |
| Accrued LNG costs                  | 1,183,191           | 391,177           |
| Accrued oil and gas property costs |                     | 250,000           |
| Other accrued liabilities          | 127,335             |                   |
| Accrued liabilities                | <u>\$ 1,347,512</u> | <u>\$ 683,788</u> |

**NOTE 4 FIXED ASSETS**

Fixed assets consist of the following:

|                                | December 31,      |                   |
|--------------------------------|-------------------|-------------------|
|                                | 2003              | 2002              |
| Furniture and fixtures         | \$ 209,514        | \$ 48,618         |
| Computers and office equipment | 524,359           | 303,151           |
| Other                          | 409,157           | 263,936           |
|                                | <u>1,143,030</u>  | <u>615,705</u>    |
| Less accumulated depreciation  | (564,749)         | (399,364)         |
| Fixed assets, net              | <u>\$ 578,281</u> | <u>\$ 216,341</u> |

**Table of Contents****CHENIERE ENERGY, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Depreciation expense related to the Company's fixed assets totaled \$165,385, \$185,396 and \$197,789 for the years ended December 31, 2003, 2002 and 2001, respectively.

**NOTE 5 OIL AND GAS PROPERTIES**

Investments in oil and gas properties consist of the following:

|   | <b>December 31,</b>  |                      |
|---|----------------------|----------------------|
|   | <b>2003</b>          | <b>2002</b>          |
| Oil and gas properties:                                   |                      |                      |
| Proved  | \$ 1,223,020         | \$ 857,388           |
| Unproved  | 18,047,802           | 16,751,347           |
|   | <u>19,270,822</u>    | <u>17,608,735</u>    |
| Less accumulated depreciation, depletion and amortization | (135,868)            | (14,506)             |
|   | <u>\$ 19,134,954</u> | <u>\$ 17,594,229</u> |

Depreciation, depletion and amortization of oil and gas property costs totaled \$121,362, \$74,566 and \$1,029,239 for the years ended December 31, 2003, 2002 and 2001, respectively. Depreciation, depletion and amortization per equivalent Mcf (using an Mcf-to-barrel conversion factor of 6 to 1) was \$0.98, \$0.79 and \$1.84 for the years ended December 31, 2003, 2002 and 2001, respectively.

Costs incurred for unproved oil and gas properties were \$2,514,357 in 2003 and \$2,813,370 in 2002. The Company believes that unproved property costs will be evaluated within four years.

At June 30, 2001 and September 30, 2001, the Company's capitalized costs exceeded its capitalization ceiling, resulting in ceiling test write-downs totaling \$5,126,248 for the year ended December 31, 2001.

The Company has made substantial investments in acquiring, processing and reprocessing its seismic databases covering a 6,800-square-mile project area offshore Texas and Louisiana and a 228-square-mile project area onshore and offshore Louisiana. The costs of these projects

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become subject to amortization on a ratable basis as the oil and gas reserves expected to be recovered from the projects are discovered. The Company began drilling prospects identified within its seismic databases in 1999, but did not participate in the drilling of any wells in 2000, 2001, 2002 or 2003. The Company did, however, have overriding royalty interests in wells drilled by others during these periods. Interpretation of this data and related prospect generation is ongoing.

In September 2001, Cheniere paid \$500,000 to acquire all rights to its 228-square-mile proprietary seismic database from the industry partner with whom it had jointly owned the data since 1996. Concurrent with this acquisition, Cheniere sold the seismic data to a seismic marketing company for \$2,500,000 and a 50% share in licensing proceeds generated by the marketing company. In September 2002, Cheniere sold its remaining interest in future licensing proceeds to the marketing company for \$825,000. Proceeds from the September 2001 and 2002 sales of 3D seismic data were recorded as a reduction to the Company's unproved oil and gas property costs. Cheniere retains a license to all of the seismic data for use in its exploration program.

In April 2002, the Company sold all of its proved working interests in oil and gas properties for \$2,235,365. A gain of \$340,257 was recorded on the sale.

### **NOTE 6 INVESTMENT IN UNCONSOLIDATED AFFILIATE**

Prior to January 1, 2003, Cheniere accounted for its investment in Gryphon Exploration Company ( Gryphon ) using the equity method of accounting because its participation on the Gryphon board of directors provided it with the ability to exercise significant influence over the operating and financial policies of Gryphon. In December 2002, the extent of such influence was diminished when one of the two Cheniere-appointed representatives on the Gryphon board of directors resigned his position as an officer of Cheniere. Accordingly, effective January 1, 2003, Cheniere began accounting for its investment in Gryphon using the cost method of accounting. As of December 31, 2002, Warburg, Pincus Equity Partners, L.P. ( Warburg ) had invested \$85,000,000 in Gryphon convertible preferred stock. If Warburg had converted its investment to common stock as of such date, Cheniere's ownership interest would have been 9.3%. This effective percent ownership remains unchanged as of December 31, 2003.

Cheniere began engaging in a series of transactions related to Gryphon in 2000. On October 11, 2000, Cheniere completed a transaction with Warburg to fund its exploration program on approximately 8,800 square miles of seismic data in the Gulf of Mexico (the Louisiana Data Set ) through a newly-formed affiliated company, Gryphon. Cheniere contributed selected assets and liabilities in exchange for 100% of the common stock of Gryphon (36.8% voting interest after conversion of preferred stock) and \$2,000,000 in

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**CHENIERE ENERGY, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

cash. Such assets included: the Louisiana Data Set, certain offshore leases, a prospect then being drilled, its exploration agreement with an industry partner and certain other assets and liabilities. The net book value of the assets and liabilities contributed was \$7,065,919, which consisted of assets of \$9,115,963 (primarily unproved oil and gas property) and liabilities of \$2,050,044 (primarily accounts payable). Warburg contributed \$25,000,000 and received preferred stock, with an 8% accrued dividend, convertible into 63.2% of Gryphon's common stock. Cheniere accounted for the contribution of net assets at its historical cost, whereby the net amount of such assets and liabilities less the \$2,000,000 in cash was reclassified to investment in affiliate. No gain or loss was recognized at the time of contribution, primarily due to Cheniere's commitment to provide additional funding described above and due to the uncertainty of realization of the carrying value of the contributed unproved oil and gas properties.

Cheniere and Warburg also have the option, in connection with subsequent capital calls made by Gryphon, to contribute up to an additional \$75,000,000 to Gryphon, proportionate to their respective ownership interests. Under the terms of the agreement governing these additional contributions, in the event that either Cheniere or Warburg elects not to participate in any additional contribution, the other investor has the option to purchase the non-participating investor's proportionate share. Assuming (i) that Gryphon makes subsequent capital calls for an aggregate of \$75,000,000, (ii) that Cheniere elects not to participate in any of the capital calls and (iii) that Warburg elects to purchase all of Cheniere's proportionate share, and giving effect to Cheniere's sale to Gryphon of 6,740 shares of Gryphon common stock in July 2001 and its sale to Gryphon of 51,400 shares of Gryphon common stock in March 2002 (see Note 6), the Company's effective interest in Gryphon, after giving effect to the conversion of Gryphon's preferred stock, would be reduced to 8.0%.

There were no cash calls in 2003. However, during 2002 and 2001, Gryphon made cash calls totaling \$60,000,000. Cheniere declined to participate in such cash calls, and Warburg elected to purchase all of Cheniere's proportionate share of such cash calls. Also during 2001, Cheniere transferred 6,740 shares of Gryphon common stock to Gryphon in connection with the sale of licenses to certain seismic data. In March 2002, Cheniere sold 51,400 shares of its Gryphon common stock to Gryphon, subject to certain repurchase options (discussed below). As a result of these transactions, Cheniere's ownership interest in Gryphon was reduced to 9.3% as of December 31, 2002.

In connection with the seismic license contributed to Gryphon upon its formation, Cheniere entered into an agreement with the third party issuer of the license. The agreement provided that Cheniere would pay a transfer fee to the third party in an aggregate amount of up to \$2,500,000. Such transfer fee was contingent upon Gryphon's completion of up to ten successful wells during the license period and within the license area. Cheniere's existing and contingent obligations under this agreement were fully discharged in March 2002 in connection with its sale of 51,400 shares of Gryphon common stock to Gryphon and the related assumption by Gryphon of these obligations.

During 2002, as a result of Gryphon's cumulative losses and preferred dividend arrearages, Cheniere's basis of its investment in Gryphon was reduced to zero, but not below zero, because Cheniere does not guarantee any obligations of Gryphon and is not committed to provide additional financial support to Gryphon. Cheniere's equity share of Gryphon's losses for 2002 was \$2,184,847, calculated by applying Cheniere's 100% common stock ownership interest to Gryphon's net loss of \$519,000, reducing such result for Gryphon's preferred dividend arrearages of \$5,844,746 for the year and limiting the cumulative amount of net loss recognized to the balance of Cheniere's investment in Gryphon. The amount of the net loss that was not recorded by Cheniere as of December 31, 2002 was \$4,179,000. For 2001, Cheniere's equity share of Gryphon's losses was \$2,974,191, calculated by applying Cheniere's 100% common stock ownership interest to Gryphon's net income of \$84,000 and reducing such result for Gryphon's preferred dividend arrearages of \$3,058,191 for the year. As of December 31, 2003, the amount of Gryphon's preferred dividends in arrears was \$17,125,936.



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Prior to January 1, 2003, activities related to Cheniere's investment in Gryphon were accounted for using the equity method of accounting. Accordingly, for the period prior to 2003, the summarized financial information relative to Gryphon is set forth below (in thousands):

|  | <b>December 31,<br/>2002</b> |
|--|------------------------------|
| Current assets                           | \$ 12,215                    |
| Oil and gas properties, full cost method | 91,007                       |
| Fixed assets                             | 458                          |
| Current liabilities                      | 11,870                       |
| Long-term liabilities                    |                              |
| Deferred tax liabilities                 | 2,043                        |

**Table of Contents****CHENIERE ENERGY, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

|   | Year Ended   |          |
|---|--------------|----------|
|   | December 31, |          |
|   | 2002         | 2001     |
| Revenues  | \$ 11,143    | \$ 2,382 |
| Income (loss) from continuing operations                  | (674)        | 82       |
| Net income (loss)   | (519)        | 84       |
| Preferred dividends in arrears                            | (5,845)      | (3,058)  |
| Cheniere's equity in losses from unconsolidated affiliate | (2,185)      | (2,974)  |

The following items represent the differences between Cheniere's equity share of Gryphon's net assets and the balance in Cheniere's investment in unconsolidated affiliate (in thousands):

|   | December 31,<br>2002 |
|---|----------------------|
| Cheniere's equity share of Gryphon's net assets | \$ 4,767             |
| Gryphon losses not yet recorded by Cheniere     | 4,179                |
| Preferred stock dividends in arrears            | (9,349)              |
| Excess of Cheniere cost basis                   | (500)                |
| Gryphon offering expenses                       | 903                  |
| Cheniere's investment basis                     | \$                   |

**NOTE 7 INVESTMENT IN LIMITED PARTNERSHIP**

In August 2002, Cheniere entered into an agreement with entities controlled by Michael S. Smith ( Smith ) to sell a 60% interest in the Freeport site and project. On February 27, 2003, Cheniere sold its interest in the site and project to Freeport LNG Development, L.P. ( Freeport LNG ), in which the Company held a 40% limited partner interest. Smith holds a 60% limited partner interest in Freeport LNG. Cheniere recovered \$1,740,426, in costs it had incurred on the project and received an additional \$5,000,000 (\$2,500,000 during 2003 and \$2,500,000 in January 2004) from Freeport LNG. For the funding of Freeport LNG project development costs, Smith also committed to contribute up to \$9,000,000 and to allocate available proceeds from any sales of options or capacity reservations and/or proceeds from loans related to capacity reservations to these costs. In connection with the closing, Cheniere issued warrants to Smith to purchase 700,000 shares of Cheniere common stock at a price of \$2.50 per share, exercisable for a period of 10 years.

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Effective March 1, 2003, Cheniere sold a 10% limited partner interest in Freeport LNG to an affiliate of Contango Oil & Gas Company ( Contango ) for \$2,333,333 payable over time, including the cancellation of the Company's \$750,000 short-term note payable. Cheniere also issued warrants to Contango to purchase 300,000 shares of Cheniere common stock at a price of \$2.50 per share, exercisable for a period of 10 years. As a result of the sale, Cheniere now holds a 30% limited partner interest in Freeport LNG.

The Company accounted for the transfer of the site and planned LNG receiving terminal to Freeport LNG in accordance with Emerging Issues Task Force Issue No. 01-2, *Interpretations of APB Opinion No. 29*. Accordingly, Cheniere recorded a \$4,760,000 gain on sale of LNG assets to the extent of the 60% interest not retained.

The Company accounts for its 30% limited partnership investment in Freeport LNG using the equity method of accounting. During 2003, Cheniere received installment payments totaling \$2,500,000 from Freeport LNG, which amounts were recorded as a reduction to the basis of the Company's investment in the partnership. In addition, Cheniere's 30% limited partner interest in the operations of Freeport LNG resulted in the Company sharing in the net loss of the partnership in the amount of \$4,471,529 for 2003. This non-cash loss reduced the basis of Cheniere's investment in Freeport LNG to zero.

The financial position of Freeport LNG at December 31, 2003 and the results of Freeport LNG's operations for the year ended December 31, 2003 and for the period from inception (December 1, 2002) through December 31, 2003 are summarized as follows (in thousands):

|  | <b>December 31,<br/>2003</b> |
|--|------------------------------|
| Current assets                                 | \$ 295                       |
| Fixed assets, net, and security deposit        | 150                          |
| <b>Total assets</b>                            | <b>\$ 445</b>                |
| Current liabilities                            | \$ 5,887                     |
| Partners' capital                              | (5,442)                      |
| <b>Total liabilities and partners' capital</b> | <b>\$ 445</b>                |

**Table of Contents****CHENIERE ENERGY, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

|  | Year Ended,<br>December 31,<br>2003 | Inception<br>(December 1, 2002)<br>through<br>December 31,<br>2003 |
|--|-------------------------------------|--|
| Loss from continuing operations                      | \$ (14,940)                         | \$ (15,832)  |
| Net loss   | (14,940)                            | (15,832)   |
| Cheniere's equity in losses from limited partnership | (4,472)                             | (4,472)  |

As of December 31, 2003, the Company's investment in Freeport LNG was reduced to zero and the amount of the net loss in the partnership not recorded by Cheniere was \$278,071.

**NOTE 8 MINORITY INTEREST IN LIMITED PARTNERSHIP**

In May 2003, Cheniere formed a limited partnership, Corpus Christi LNG, L.P. ( Corpus LNG ) to develop an LNG receiving terminal near Corpus Christi, Texas. Under the terms of the limited partnership agreement, Cheniere contributed its technical expertise and know-how, and all of the work in progress related to the Corpus Christi project, in exchange for a 66.7% interest in Corpus LNG.

Cheniere's consolidated financial statements include the accounts of Corpus LNG. The \$3,015,468 minority interest included in the consolidated statement of operations for the year ended December 31, 2003 is equal to the entire net loss of Corpus LNG due to Cheniere's investment basis being zero and the minority owner's 100% funding of project expenses through December 31, 2003.

**NOTE 9 NOTES PAYABLE**

At December 31, 2003, Cheniere had an outstanding debt obligation of \$1,000,000 on its line of credit with a commercial bank. The balance was repaid in January 2004. At December 31, 2002, Cheniere had a \$750,000 short-term note payable outstanding. This note was canceled in March 2003 as discussed below.

Set forth below is a description of financing facilities used by the Company under which financing cash inflows and outflows occurred during the three years ended December 31, 2003.

**July 2003 Commercial Bank Financing**

In July 2003, Cheniere established a \$5,000,000 line of credit with a commercial bank, with an initial borrowing base of \$2,000,000. The facility is secured by the assets of the Company, and its term, as amended, runs through December 31, 2004. Borrowings bear interest at the bank's prime rate plus 2.5% per annum, and a commitment fee of 0.5% per annum is assessed on the unused borrowing base capacity. The interest and commitment fee are payable quarterly. A loan origination fee of 1% of the initial borrowing base was paid at closing. At December 31, 2003, Cheniere had a debt obligation of \$1,000,000 and an \$865,142 letter of credit outstanding against this line of credit. The \$1,000,000 debt obligation was repaid in January 2004.

**February 2003 Promissory Note**

In February 2003, Cheniere executed a promissory note payable in the amount of \$225,000. The proceeds of the note were used to pay certain costs related to the Company's 3-D seismic database.

The note bore interest at a rate of approximately 12% per annum and was secured by a pledge of the Company's oil and gas receivables. In July 2003, Cheniere repaid the balance outstanding on the promissory note payable. The note and related security agreement were canceled.

**June 2002 LNG Receiving Terminal Financing**

In June 2002, Cheniere received a \$750,000 payment for the sale of two options to purchase an aggregate of up to a 20% interest in its Freeport LNG receiving terminal project. The payment was refundable in the event an option was not exercised. The potential repayment was secured by an 8% note payable executed by Cheniere. In March 2003, an option was exercised, the note payable canceled, and the payment applied to the purchase price per the terms of the agreement.

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**CHENIERE ENERGY, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**March 2002 \$500,000 Bridge Financing**

In March 2002, the Company entered into a short-term bridge financing arrangement with an unrelated third-party lender. The amount of the borrowing was \$500,000. The term was 120 days. Interest was payable monthly at 10% per annum. Warrants were issued to the lender for the purchase of 150,000 shares of Cheniere common stock, exercisable at a price of \$2.50 per share on or before March 7, 2012. In addition, Cheniere extended the term to March 7, 2012 on existing warrants for the purchase of 255,417 shares held by parties affiliated with the lender. Based on the Black-Scholes model, the warrants issued (150,000 shares) and the extension of existing warrants (255,417 shares) in connection with this financing arrangement have an aggregate value of \$241,939. Debt discount of \$163,045 was recorded based on the relative fair values of the note payable and the warrants. An additional 50,000 warrants were required to be issued to the lender for each month or partial month for which the principal remained unpaid after April 7, 2002. The Company repaid the loan on April 22, 2002, resulting in a loss on early extinguishment of debt in the amount of \$100,544, which is classified as an ordinary loss in the Company's statement of operations. Cheniere also issued an additional 50,000 warrants to the lender, valued at \$24,054 based on the Black-Scholes model.

**NOTE 10 DEFERRED REVENUE**

On December 23, 2003, Cheniere LNG Services, Inc. (Cheniere LNG Services), a wholly-owned subsidiary of Cheniere, entered into a shareholders agreement whereby it became a minority owner of J&S Cheniere S.A., a Switzerland joint-stock company (J&S Cheniere). The majority owner is J&S Group S.A. (J&S Group). J&S Cheniere was formed for the purpose of buying, selling and trading LNG. Under the shareholders agreement, Cheniere LNG Services identifies and assists with LNG-related business opportunities that it determines are appropriate for J&S Cheniere. Cheniere LNG Services is not required to offer any particular business opportunities nor funding to J&S Cheniere. Cheniere LNG Services has no board of director representation nor does it participate in the day-to-day management of J&S Cheniere. All financing of the business opportunities will be provided by J&S Group should it determine that a business opportunity is appropriate for J&S Cheniere. However, J&S Group is not required to fund any particular business opportunity. Cheniere accounts for this investment using the cost method of accounting. At December 31, 2003, Cheniere's investment basis was zero.

Also on December 23, 2003, Cheniere LNG, Inc. (Cheniere LNG), a wholly-owned subsidiary of Cheniere, and J&S Cheniere entered into an option agreement providing J&S Cheniere an option to purchase LNG storage tank capacity and regas capacity of up to 200 Mmcf/d in each of Cheniere LNG's Sabine Pass and Corpus Christi LNG facilities. Following execution of the option agreement, \$1,000,000 was paid by J&S Cheniere to Cheniere LNG in January 2004. At December 31, 2003, the \$1,000,000 was included in accounts receivable. It was recorded as deferred revenue because the option fee is refundable if Cheniere LNG does not receive FERC approval for at least one of the terminals or it does not proceed with the development of at least one of the terminals. Upon FERC approval and other related approvals and receipt of permits for each terminal, J&S Cheniere has 60 days to exercise its option at each terminal. The option agreement contemplates negotiation of a definitive terminal use agreement for each of the facilities, which will specify the terms and conditions of the purchase and sale of the capacity and related services. Cheniere LNG will record the option fee as revenue once it is no longer subject to refund.

**NOTE 11 INCOME TAXES**

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From its inception, the Company has recorded losses for both financial reporting purposes and for federal income tax reporting purposes. Accordingly, the Company is not presently a taxpayer and has not recorded a provision for income taxes in any of the periods presented in the accompanying financial statements.

At December 31, 2003, the Company had net operating loss ( NOL ) carryforwards for tax reporting purposes of approximately \$26,500,000. In accordance with SFAS No. 109, a valuation allowance equal to the net tax benefit for deferred taxes has been established due to the uncertainty of realizing the benefit of such NOL carryforwards.

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## CHENIERE ENERGY, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Deferred tax assets and liabilities reflect the net tax effect of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and amounts used for income tax purposes. Significant components of the Company's deferred tax assets and liabilities at December 31, 2003 and 2002 are as follows:

|   | December 31,      |                  |
|---|-------------------|------------------|
|   | 2003              | 2002             |
| Deferred tax assets                     |                   |                  |
| NOL carryforwards                       | \$ 9,809,102      | \$ 8,226,583     |
| Oil and gas properties and fixed assets |                   | 70,169           |
| Investment in unconsolidated affiliate  | 513,190           | 513,190          |
| LNG Terminal Development                | 1,303,499         |                  |
|   | <u>11,625,791</u> | <u>8,809,942</u> |
| Deferred tax liabilities                |                   |                  |
| Oil and gas properties and fixed assets | 56,181            |                  |
|   | <u>56,181</u>     |                  |
| Net deferred tax assets                 | 11,569,610        | 8,809,942        |
| Less: valuation allowance               | (11,569,610)      | (8,809,942)      |
|   | <u>\$</u>         | <u>\$</u>        |

NOL carryforwards expire starting in 2012 extending through 2023. Certain of the Company's NOLs are subject to per year availability under Internal Revenue Code Section 382 change of ownership limitations.

The gross change in the valuation allowance for deferred tax assets was approximately \$2,759,668, \$(2,582,183) and \$7,739,165 during the years ended December 31, 2003, 2002 and 2001, respectively.

## NOTE 12 WARRANTS



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As of December 31, 2003, Cheniere has issued and outstanding 1,299,583 warrants for the purchase of its common stock. The Company has reserved an equal number of shares of common stock for issuance upon the exercise of its outstanding warrants. Warrants issued by the Company do not confer upon the holders thereof any voting or other rights of a stockholder of the Company. The Company has granted warrants in connection with certain of its debt or equity financings and as compensation for services. In instances where warrants were granted in connection with financings, such warrants were valued based on the estimated fair market value of the stock at the date of issuance. Where warrants were issued for services, fair value was calculated using the Black-Scholes pricing model. The terms of warrants outstanding at December 31, 2003 range from approximately three to fourteen years, with a weighted average remaining life of 5.5 years. Prices at which the warrants are exercisable range from \$1.06 to \$11.50 per share, with a weighted average exercise price of \$3.30 per share at December 31, 2003. Information related to Cheniere's warrants is summarized in the following table:

|   | December 31, |           |           |
|---|--------------|-----------|-----------|
|   | 2003         | 2002      | 2001      |
| Outstanding at beginning of period                                  | 2,593,521    | 2,850,288 | 2,758,621 |
| Warrants issued   | 1,716,250    | 312,500   | 91,667    |
| Warrants exercised  | (1,082,093)  |           |           |
| Warrants canceled   | (1,928,095)  | (569,267) |           |
| Outstanding at end of period  | 1,299,583    | 2,593,521 | 2,850,288 |
| Weighted average exercise price of warrants outstanding             | \$ 3.30      | \$ 4.06   | \$ 4.47   |
| Weighted average remaining contractual life of warrants outstanding | 5.5 years    | 2.7 years | 1.8 years |

**Table of Contents****CHENIERE ENERGY, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table summarizes information about warrants outstanding at December 31, 2003:

| <u>Exercise Prices</u> |         | <u>Number</u>      | <u>Weighted Average</u> |
|------------------------|---------|--------------------|-------------------------|
|                        |         | <u>Outstanding</u> | <u>Years Remaining</u>  |
|                        |         |                    | <u>Contractual Life</u> |
| \$9.50                 | \$11.50 | 25,000             | 0.7                     |
|                        | \$7.50  | 12,500             | 0.7                     |
| \$5.50                 | \$6.00  | 276,250            | 6.4                     |
|                        | \$3.00  | 50,000             | 1.3                     |
|                        | \$2.50  | 725,000            | 6.8                     |
| \$1.06                 | \$1.75  | 210,833            | 1.8                     |
|                        |         | <u>1,299,583</u>   |                         |

In February 2003, in connection with the sale of a 60% interest in its Freeport LNG project, the Company issued warrants valued at \$540,015 to purchase 700,000 shares of Cheniere common stock. The Company also issued warrants to purchase 241,250 shares of Cheniere common stock to a former employee of the Company and the current President and Chief Operating Officer of Freeport LNG, in replacement of his options to purchase 241,250 shares of Cheniere common Stock. The number and exercise prices of the warrants were the same as the options replaced and ranged from \$1.06 to \$12.00 per share. The Company issued warrants valued at \$173,576 to purchase 225,000 shares of Cheniere common stock to LNG consultants for services previously performed for the Company. In connection with the sale of a 10% interest in the limited partnership, the Company issued warrants valued at \$241,893 to purchase 300,000 shares of Cheniere common stock to the purchaser.

In April 2003, the Company issued warrants to purchase 250,000 shares of Cheniere common stock at \$2.50 per share to its Chief Executive Officer as a signing bonus. At the time of issue, the current market price was \$1.80 per share. The warrants vest one year from the date of issue.

In August 2003, the Company issued 378,308 shares of common stock in exchange for the surrender of warrants to purchase 700,000 shares in a cashless transaction. The warrants were exercisable at \$2.50 per share based on the then-current market price of \$5.44 per share.

**NOTE 13 STOCK-BASED COMPENSATION**

In 1997, the Company established the Cheniere Energy, Inc. 1997 Stock Option Plan, as amended (the Option Plan), which allows for the issuance of options to purchase up to 2,500,000 shares of Cheniere common stock. The Company has reserved 2,500,000 shares of common

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stock for issuance upon the exercise of options which have been granted or which may be granted. The Company had granted options on 2,147,500 shares which were outstanding or had been exercised as of December 31, 2003. The term of options granted under the Option Plan is generally five years. Vesting varies, but generally occurs over three or four years, in increments of 33% or 25%, respectively, on each anniversary of the grant date. All options granted under the Option Plan have exercise prices equal to or greater than fair market value at the date of grant.

**Table of Contents****CHENIERE ENERGY, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

A summary of the status of the Company's stock options is presented below:

|  | December 31,     |                  |                  |
|--|------------------|------------------|------------------|
|  | 2003             | 2002             | 2001             |
| Outstanding at beginning of period                                 | 1,983,611        | 1,741,111        | 884,236          |
| Options granted at an exercise price of \$4.62 per share           | 50,000           |                  |                  |
| Options granted at an exercise price of \$4.45 per share           | 50,000           |                  |                  |
| Options granted at an exercise price of \$2.70 per share           | 50,000           |                  |                  |
| Options granted at an exercise price of \$2.38 per share           |                  |                  | 20,000           |
| Options granted at an exercise price of \$2.16 per share           |                  |                  | 20,000           |
| Options granted at an exercise price of \$1.85 per share           | 250,000          |                  |                  |
| Options granted at an exercise price of \$1.70 per share           |                  |                  | 100,000          |
| Options granted at an exercise price of \$1.45 per share           | 50,000           |                  |                  |
| Options granted at an exercise price of \$1.44 per share           | 20,000           |                  |                  |
| Options granted at an exercise price of \$1.27 per share           | 20,000           |                  |                  |
| Options granted at an exercise price of \$1.25 per share           |                  | 267,500          |                  |
| Options granted at an exercise price of \$1.20 per share           |                  | 30,000           |                  |
| Options granted at an exercise price of \$1.06 per share           |                  |                  | 760,000          |
| Options granted at an exercise price of \$0.93 per share           |                  | 50,000           |                  |
| Options exercised  | (187,500)        |                  |                  |
| Options converted to warrants                                      | (241,250)        |                  |                  |
| Options canceled / expired   | (84,861)         | (105,000)        | (43,125)         |
| <b>Outstanding at end of period</b>                                | <b>1,960,000</b> | <b>1,983,611</b> | <b>1,741,111</b> |
| <b>Exercisable at end of period</b>                                | <b>1,161,980</b> | <b>1,106,111</b> | <b>664,444</b>   |
| Weighted average exercise price of options outstanding             | \$ 2.23          | \$ 2.07          | \$ 2.21          |
| Weighted average exercise price of options exercisable             | \$ 2.49          | \$ 2.56          | \$ 3.16          |
| Weighted average fair value of options granted during the period   | \$ 1.60          | \$ 1.20          | \$ 0.76          |
| Weighted average remaining contractual life of options outstanding | 2.9 years        | 3.4 years        | 4.1 years        |

The following table summarizes information about fixed options outstanding at December 31, 2003:

Options Outstanding

Options

| <u>Exercise Prices</u> | <u>Weighted Average</u> |                         | <u>Exercisable</u> |
|------------------------|-------------------------|-------------------------|--------------------|
|                        | <u>Number</u>           | <u>Years Remaining</u>  | <u>Number</u>      |
|                        | <u>Outstanding</u>      | <u>Contractual Life</u> | <u>Outstanding</u> |
| \$6.00                 | 210,000                 | 0.8                     | 205,313            |
| \$4.62                 | 50,000                  | 4.6                     | 25,000             |
| \$4.45                 | 50,000                  | 4.5                     |                    |
| \$2.75                 | 175,000                 | 1.6                     | 175,000            |
| \$2.70                 | 50,000                  | 4.4                     |                    |
| \$2.38                 | 20,000                  | 2.0                     | 13,333             |
| \$2.16                 | 20,000                  | 2.1                     | 13,333             |
| \$1.94                 | 237,500                 | 1.9                     | 237,500            |
| \$1.85                 | 250,000                 | 4.3                     |                    |
| \$1.45                 | 50,000                  | 4.0                     |                    |
| \$1.44                 | 20,000                  | 3.1                     | 6,667              |
| \$1.27                 | 20,000                  | 4.1                     |                    |
| \$1.25                 | 247,500                 | 4.0                     | 122,500            |
| \$1.20                 | 30,000                  | 3.7                     | 10,000             |
| \$1.06                 | 480,000                 | 2.9                     | 336,667            |
| \$0.93                 | 50,000                  | 3.8                     | 16,667             |
|                        | <u>1,960,000</u>        |                         | <u>1,161,980</u>   |

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**CHENIERE ENERGY, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 14 RELATED PARTY TRANSACTIONS**

In December 2003, Cheniere LNG Services entered into a shareholders agreement whereby Cheniere LNG Services acquired a minority interest in J&S Cheniere. One of the directors of J&S Cheniere is the brother of Charif Souki, Cheniere's Chairman, President and Chief Executive Officer.

In April 2002, Charles M. Reimer, Cheniere's then-President, advanced amounts totaling \$30,000 to the Company. Subsequent to its sale of producing oil and gas properties, Cheniere repaid the advances on April 25, 2002, with accrued interest at 10% per annum totaling \$122.

In March 2002, Cheniere sold 51,400 shares of its Gryphon common stock to Gryphon, subject to an option to repurchase the shares, thereby reducing its interest in Gryphon from 20.2% to 13.7% on an as-converted basis. Such sale was made in connection with the settlement of a lawsuit filed by Fairfield Industries Incorporated against Cheniere and Gryphon. In connection with its sale of Gryphon common stock to Gryphon, Cheniere had a one-year option to repurchase all or a portion of the 51,400 shares at a price of \$50 per share if exercised within 120 days of the sale or at prices increasing ratably thereafter to approximately \$68 per share one year after the sale. As consideration for the shares, Gryphon agreed to make payments in full satisfaction of certain existing and contingent obligations of Cheniere totaling \$3,561,692. Cheniere, Gryphon and Fairfield Industries reached a settlement agreement whereby a lawsuit and related claims asserted by Fairfield against Cheniere and Gryphon were dismissed.

In conjunction with certain of the Company's private placements of equity in 2001, placement fees have been paid to Investors Administration Services, Limited (IAS), a company in which the brother of Charif Souki, Cheniere's then-Chairman, was a principal. Placement fees to IAS totaled \$30,000 for 2001 and were expensed.

Commencing October 1, 2001, Cheniere has made office space available for use by Keith F. Carney, a non-management director. The pro rata amount of office lease expense related to that space was \$4,400, \$4,500 and \$1,125 in 2003, 2002 and 2001, respectively.

In September 2001, the Company made a payment of \$40,000 to Charif Souki, its then-Chairman, representing consulting fees for the months of October 2001 through January 2002.

In July 2001, Cheniere sold to Gryphon one of its two licenses to certain 3D seismic data covering an additional 3,000 square miles. Gryphon agreed to pay Cheniere's accounts payable of \$1.3 million and the remaining commitment of \$2.9 million related to the reprocessing of the data. In connection with the transaction, Cheniere also transferred to Gryphon 6,740 shares of Gryphon common stock, valued at approximately \$418,000 or \$62 per share, based on the estimated fair market value of the Gryphon common stock, which considered the fair value of such stock at the formation of Gryphon and any significant changes in Gryphon's operations or market conditions since that date. The proceeds at

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closing of \$1.3 million were allocated as a reduction to the carrying amount of Cheniere's investment in Gryphon (\$418,000) and unproved oil and gas properties (\$882,000). Cheniere retains one license to the seismic data.

In June 2001, Cheniere sold to Gryphon for \$3,500,000 one of its two licenses to the Seitel 3D seismic data. Gryphon paid \$853,197 in cash to Cheniere and agreed to pay \$2,646,803 of Cheniere's obligations related to the reprocessing of the data. Cheniere remained responsible for payment of the final \$1,061,692 in reprocessing charges upon final delivery of all reprocessed data, which was received in 2003. This payment obligation was assumed by Gryphon in connection with Cheniere's March 2002 sale of 51,400 shares of Gryphon common stock to Gryphon.

In April 2001, the Company sold an interest in a prospect to Gryphon. Gryphon paid Cheniere \$225,563 for a 50% interest in the related leases and will pay a disproportionate share of the drilling costs on terms representative of what a third party would pay for participation in the prospect generated by Cheniere.

### **NOTE 15 COMMITMENTS AND CONTINGENCIES**

#### **Lease Commitments**

In November 2000, the Company entered into an office lease agreement with a term, as extended, which ran through March 31, 2004. In October 2003, the Company entered into a lease agreement related to new office space with a term which runs from December 2003 through April 2014. Beginning in April 2004, Cheniere's monthly lease rental is \$21,543 and escalates to \$24,235 beginning in February 2009 through the remaining term of the lease. The Company has an option to renew the lease for an additional five years at the then-current market rate. Cheniere is also responsible for its proportionate share of the building operating expenses. In

**Table of Contents****CHENIERE ENERGY, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

connection with the lease, Cheniere has issued a letter of credit in favor of the landlord in the amount of \$865,142. In addition, the lease creates a lien on all property that Cheniere places on the premises as a security interest for payment of amounts due under the terms of the lease.

In December 2003, the Company entered an agreement to lease software for use in its exploration activities. This lease provides for annual payments of \$230,000 per year to be made prior to the beginning of each contract year. The lease runs through December 31, 2006.

Future annual minimum lease payments are as follows:

| <b>Year Ending</b>  | <b>Operating</b>    |
|---------------------|---------------------|
| <b>December 31,</b> | <b>Lease</b>        |
| 2004                | \$ 455,000          |
| 2005                | 522,000             |
| 2006                | 299,000             |
| 2007                | 305,000             |
| 2008                | 305,000             |
| Thereafter          | 1,711,000           |
| <b>Total</b>        | <b>\$ 3,597,000</b> |

Cheniere's total rental expense for office space for the years ending December 31, 2003, 2002 and 2001 was \$128,351, \$131,038 and \$157,146, respectively.

**LNG Commitments**

In connection with the acquisition of the option to lease the Freeport LNG receiving terminal site in June 2001, Cheniere issued 500,000 shares of common stock valued at \$1,150,000, or \$2.30 per share, the closing price of Cheniere's common stock on the date of the transaction, to the seller of the lease option. The Company also committed to issue an additional 750,000 shares of its common stock to the seller of the lease option in April 2003, for which Cheniere received no additional consideration. These shares were issued in April 2003 at a value of \$1,312,500, or \$1.75 per share, the closing price of Cheniere's common stock on the date of issuance. The seller of the lease option also obtained the right to receive a royalty payment on the gross quantities of gas processed through LNG terminals owned by Cheniere LNG. The royalty is calculated based on \$0.03 per Mcf on the quantities of gas processed through LNG terminals that Cheniere owns, subject to a maximum royalty of approximately \$10,950,000 per year. In 2002, a long-term lease was secured by Freeport LNG, and at the closing of the sale of Cheniere's interests in the site and project, Freeport LNG assumed the obligation to pay the royalty with respect to gas processed and produced at the



Freeport LNG facility.

The Company's obligations under LNG site options are renewable on an annual or semiannual basis. Cheniere may terminate its obligations at any time by electing not to renew or by exercising the options.

On December 23, 2003, Cheniere LNG and J&S Cheniere entered into an option agreement under which J&S Cheniere has an option to purchase LNG storage tank capacity and regas capacity of up to 200 Mmcfd day in each of Cheniere LNG's Sabine Pass and Corpus Christi LNG facilities. Following execution of the option agreement, \$1,000,000 was paid by J&S Cheniere to Cheniere LNG in January 2004. The option fee is refundable if Cheniere LNG does not receive Federal Energy Regulatory Commission (FERC) approval for at least one of the terminals or it does not proceed with the development of at least one of the terminals. Upon FERC approval and other related approvals and receipt of permits for each terminal, J&S Cheniere has 60 days to exercise its option at each terminal. The option agreement contemplates negotiation of a definitive TUA for each of the facilities, which will specify the terms and conditions of the purchase and sale of the capacity and related services.

### **Legal proceedings**

The Company has been and may in the future be involved as a party to various legal proceedings, which are incidental to the ordinary course of business. Management regularly analyzes current information and as necessary, provides accruals for probable liabilities on the eventual disposition of these matters. In the opinion of management and legal counsel, as of December 31, 2003, there were no threatened or pending legal matters that would have a material impact on the Company's consolidated results of operations, financial position or cash flows.

**Table of Contents****CHENIERE ENERGY, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****NOTE 16 BUSINESS SEGMENT INFORMATION**

The Company's business activities are conducted within two principal operating segments: LNG receiving terminal development and oil and gas exploration and development. These segments operate independently, and there are no intercompany revenues or expenses between them.

The LNG receiving terminal segment develops LNG receiving terminals in the United States. An experienced LNG development team has been assembled and is actively working on developing LNG receiving terminals on the U.S. Gulf Coast.

The exploration and development segment explores for oil and natural gas using a regional database of 7,000 square miles of regional 3D seismic data. Exploration efforts are focused on the shallow waters of the Gulf of Mexico offshore of Louisiana and Texas and consist primarily of seismic data interpretation and prospect generation activities. The segment participates in drilling and production operations with industry partners on the prospects that Cheniere generates. In April 2002, Cheniere sold all of its working interest in producing properties at that time. During the second half of 2002 and all of 2003, all of Cheniere's revenue resulted from overriding royalty interests in new oil and gas discoveries.

|   | Segments                     |   |             | Corporate<br>and<br>Other(1) | Total<br>Consolidated |
|---|------------------------------|---|-------------|------------------------------|-----------------------|
|   | LNG<br>Receiving<br>Terminal | Oil & Gas<br>Exploration and<br>Development | Total       |                              |                       |
| As of or for the Year Ended December 31, 2003:  |                              |   |             |                              |                       |
| Revenues  | \$                           | \$ 657,467                                  | \$ 657,467  | \$                           | \$ 657,467            |
| Depreciation, Depletion, and Amortization       | 141,933                      | 191,745                                     | 333,678     | 95,002                       | 428,680               |
| Income (loss) from operations                   | (6,846,471)                  | 465,723                                     | (6,380,748) | (2,637,402)                  | (9,018,150)           |
| Equity in net loss of equity method investee(2) | (4,471,529)                  |   | (4,471,529) |                              | (4,471,529)           |
| Gain on sale of LNG assets(3)                   | 4,760,000                    |   | 4,760,000   |                              | 4,760,000             |
| Gain on sale of limited partnership interest(4) | 423,454                      |   | 423,454     |                              | 423,454               |
| Total Assets                                    | 2,952,816                    | 20,219,541                                  | 23,172,357  | 1,418,400                    | 24,590,757            |
| Investment in equity method investees           |                              |   |             |                              |                       |
| Expenditures for additions to long-lived assets |                              | 2,553,794                                   | 2,553,794   | 532,879                      | 3,086,673             |

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| As of or for the Year Ended December 31, 2002:  |             |             |             |             |             |           |
|---|-------------|-------------|-------------|-------------|-------------|-----------|
| Revenues  | \$          | \$          | 239,055     | \$          | \$          | 239,055   |
| Depreciation, Depletion, and Amortization       | 108,600     | 190,311     | 298,911     | 69,651      | 368,562     |           |
| Income (loss) from operations                   | (1,665,482) | (41,294)    | (1,706,776) | (1,988,131) | (3,694,907) |           |
| Equity in net loss of equity method investee(5) |             | (2,184,847) | (2,184,847) |             | (2,184,847) |           |
| Gain on sales of assets(6)                      |             | 340,257     | 340,257     |             | 340,257     |           |
| Total Assets                                    | 2,506,584   | 17,730,029  | 20,236,613  | 822,777     | 21,059,390  |           |
| Investment in equity method investees           |             |             |             |             |             |           |
| Expenditures for additions to long-lived assets | 125,000     | 2,828,381   | 2,953,381   | 14,506      | 2,967,887   |           |
| As of or for the Year Ended December 31, 2001:  |             |             |             |             |             |           |
| Revenues  | \$          | \$          | 2,372,632   | \$          | \$          | 2,372,632 |
| Depreciation, Depletion, and Amortization       | 16,800      | 1,115,647   | 1,132,447   | 111,381     | 1,243,828   |           |
| Ceiling test write-down(7)                      |             | 5,126,248   | 5,126,248   |             | 5,126,248   |           |
| Income (loss) from operations                   | (2,149,299) | (4,375,566) | (6,524,865) | (2,184,784) | (8,709,649) |           |
| Equity in net loss of equity method investee(5) |             | (2,974,191) | (2,974,191) |             | (2,974,191) |           |
| Total Assets                                    | 1,367,190   | 22,724,819  | 24,092,009  | 931,667     | 25,023,676  |           |
| Investment in equity method investees           |             | 3,747,199   | 3,747,199   |             | 3,747,199   |           |
| Expenditures for additions to long-lived assets | 1,350,000   | 5,067,039   | 6,417,039   | 248,386     | 6,665,425   |           |

- (1) Includes corporate activities and certain intercompany eliminations.
- (2) Represents equity in net loss of Cheniere's investment in Freeport LNG. The Company's investment basis was reduced to zero as of December 31, 2003.
- (3) In February 2003, Cheniere sold a 60% interest in its Freeport LNG terminal project to Freeport LNG. A gain of \$4,760,000 was recognized on the sale. See Note 7 to the Consolidated Financial Statements.
- (4) In March 2003, Cheniere sold a 10% limited partner interest in Freeport LNG to a third party and recognized a gain of \$423,454. See Note 7 to the Consolidated Financial Statements.
- (5) For the years 2002 and 2001, Cheniere recognized losses of \$2,184,847 and \$2,974,191, respectively, on its equity investment in Gryphon. Its investment basis was reduced to zero as of December 31, 2002. Effective January 1, 2003, Cheniere began using the cost method of accounting for this investment. See Note 6 to the Consolidated Financial Statements.
- (6) In April 2002, the Company sold its producing wells and recognized a gain of \$340,257.
- (7) During 2001, the Company was required to write down its investment in oil and gas properties in accordance with full cost accounting rules. See Note 2 to the Consolidated Financial Statements.

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**CHENIERE ENERGY, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 17 SUPPLEMENTAL CASH FLOW DISCLOSURES AND DISCLOSURES OF NON-CASH TRANSACTIONS**

In December 2003 in connection with the Corpus Christi LNG project, the minority interest owner contributed two tracts of land valued at \$310,500 to be used for the LNG terminal site.

In August 2003, the Company issued 378,308 shares of common stock in exchange for the surrender of warrants to purchase 700,000 shares in a cashless transaction. The warrants were exercisable at \$2.50 per share based on the then-current market price of \$5.44 per share.

In April 2003, pursuant to a contingent contractual obligation related to Cheniere's 2001 acquisition of an option to lease the Freeport LNG terminal site, the Company issued 750,000 shares of its common stock, valued at \$1,312,500 on the date of issuance, to satisfy a closing requirement related to Cheniere's February 2003 sale of a 60% interest in its Freeport LNG project.

In February 2003, in connection with the sale of a 60% interest in its Freeport LNG site and project, the Company issued warrants valued at \$540,015 to purchase 700,000 shares of Cheniere common stock. As a result of the closing on the Freeport transaction, the Company issued warrants valued at \$173,576 to purchase 225,000 shares of Cheniere common stock to LNG consultants for services previously performed for the Company. In connection with the sale of a 10% interest in Freeport LNG, the Company issued warrants valued at \$241,893 to purchase 300,000 shares of Cheniere common stock to the purchaser, and the purchaser canceled the \$750,000 note previously payable by Cheniere. These transactions are described in more detail in Notes 7 and 15 to the Consolidated Financial Statements.

In 2002, Cheniere transferred computer equipment with a net book value of \$29,001 to an exploration consulting company as compensation for its services. The Company sold 51,400 shares of its Gryphon common stock to Gryphon in consideration for their assumption of certain existing and contingent liabilities of Cheniere totaling \$3,561,692. In connection with the sale of the Company's proved oil and gas properties, Cheniere issued warrants to purchase 50,000 shares of Cheniere common stock to a consultant valued at \$22,695. The Company issued warrants to purchase 200,000 shares of Cheniere common stock and extended the expiration period on existing warrants to purchase 255,417 shares of Cheniere common stock, all at a value of \$265,993, in connection with a short-term bridge financing arrangement with an unrelated third-party lender. Cheniere issued warrants to purchase 50,000 shares of Cheniere common stock to a consultant valued at \$39,269 for assistance in marketing the Company's LNG terminal capacity. The Company issued 12,500 stock options valued at \$10,435 to a consultant for assistance in developing the LNG terminal business. Cheniere issued warrants to purchase 12,500 shares of Cheniere common stock to an investor relations consultant valued at \$10,435. During 2002, the Company accrued an additional \$96,777 for the services of an LNG project consultant. As of December 31, 2002, Cheniere had an accrued liability to this consultant of \$366,777, of which \$166,777 was the estimated value of warrants to be issued to purchase 225,000 shares of Cheniere common stock. These warrants were issued in February 2003 at an exercise price of \$2.50 per common share.

In 2001, Cheniere issued warrants to a consultant to purchase 50,000 shares of Cheniere common stock valued at \$93,000. The Company issued 500,000 shares valued at \$1,150,000 to acquire an LNG site lease option at Freeport. The Company sold 6,740 shares of Gryphon common stock with a fair market value of \$417,880 to Gryphon in connection with the sale of a license to 3D seismic data; additional value ascribed to the sale

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of seismic data was \$256,141 (see Note 14 to Consolidated Financial Statements). In connection with the Company's sale of licenses to 3D seismic data to Gryphon, Gryphon assumed liabilities for reprocessing charges of \$6,820,824 and made a payment on behalf of Cheniere in the amount of \$5,847,533 during 2001. The Company accrued \$270,000 as of December 31, 2001, related to an obligation to issue to a consultant an equity participation in its Freeport LNG project. The Company issued 25,000 stock options valued at \$17,000 to a consultant for assistance in securing long-term supplies of LNG.

The Company paid \$41,107, \$55,920 and \$105,813 for interest in the years ended December 31, 2003, 2002 and 2001, respectively. The Company has not paid any income taxes in the three years ended December 31, 2003.

The values of securities issued by the Company in connection with the transactions described above are based on third party arms-length negotiated prices or the fair value as calculated using the Black-Scholes pricing model.

### **NOTE 18 LIQUIDITY**

The financial statements as of December 31, 2001 were prepared on a going concern basis, which contemplated continuity of operations, realization of assets and liquidation of liabilities in the ordinary course of business. As of December 31, 2001, the Company had experienced recurring losses from operations and, during 2001, had negative cash flows from operating activities. In addition, the Company had a working capital deficiency of \$530,242 and an accumulated deficit of \$18,024,485 as of December 31, 2001. These considerations raised substantial doubt about Cheniere's ability to continue as a going concern as of December 31, 2001.

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**CHENIERE ENERGY, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

At December 31, 2003, however, Cheniere's working capital was \$155,526. In January 2004, Cheniere received net proceeds of \$13,884,750 from a private placement of 1,100,000 shares of Cheniere common stock. The Company also received the remaining \$2,500,000 from Freeport LNG, which was payable pursuant to the sale of Cheniere's 60% interest in the Freeport LNG project. Also, in January and February 2004, a total of 557,056 shares were issued pursuant to exercises of warrants and stock options resulting in additional net proceeds of \$1,309,559. The pro forma effect of these transactions, had they been consummated as of December 31, 2003, would have been to increase Cheniere's working capital to \$17,849,835.

Management expects that it will meet all of its liquidity requirements for the next twelve months through a combination of cash balances, collection of receivables, issuances of our debt or equity securities, issuances of common stock pursuant to exercises by the holders of existing warrants and options, sales of regas capacity in its planned LNG receiving terminals, sales of prospects generated by its exploration group, borrowings under its line of credit and cash flows from current operations.

**NOTE 19 SUBSEQUENT EVENTS**

In January 2004, the Company issued 1,100,000 shares of Cheniere common stock in a private placement under Regulation D to twelve accredited investors for a total consideration of \$14,850,000, or \$13.50 per share. The Company paid a 6.5% sales commission totaling \$965,250, resulting in \$13,884,750 in net proceeds received from the offering. The proceeds of the private placement will be used primarily for the development of LNG receiving terminals and for general corporate purposes.

In January 2004, the Company repaid the \$1,000,000 balance owing under its \$5,000,000 line of credit with a commercial bank using proceeds from the private placement of Cheniere common stock and other available funds.

In January and February 2004, 472,056 shares of Cheniere common stock were issued pursuant to the exercise of stock options, resulting in net cash proceeds of \$922,059. An additional 131,751 shares of Cheniere common stock were issued in a cashless exercise of options to purchase 157,945 shares.

In January and February 2004, a total of 85,000 shares of Cheniere common stock were issued pursuant to the exercise of warrants. Proceeds of \$387,500 were received at the exercise prices.

In January 2004, Cheniere received the remaining \$2,500,000 from Freeport LNG, which was payable pursuant to Cheniere's sale of its 60% interest in the Freeport LNG project. This payment to Cheniere was accelerated as a result of Freeport LNG completing a transaction for the sale of terminal capacity for which Freeport LNG received payment of a capacity reservation fee of \$10,000,000 in January 2004. This \$2,500,000 payment to Cheniere was recorded in January 2004 as a reimbursement from limited partnership investment as Cheniere's investment in Freeport

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LNG had been reduced to zero as of December 31, 2003.

On January 29, 2004, Cheniere's shareholders approved the Cheniere Energy, Inc. 2003 Stock Incentive Plan (the 2003 Plan). The 2003 Plan is a broad-based incentive plan, which allows for the issuance of stock options, purchased stock awards, bonus stock awards, stock appreciation rights, phantom stock awards, restricted stock awards, performance awards, and other stock or performance-based awards to employees, consultants and non-employee directors to purchase up to 1,000,000 shares of Cheniere common stock. The Company has reserved 1,000,000 shares of common stock for issuance upon the exercise of awards that have been granted or which may be granted. The term of any award under the 2003 Plan may not exceed a period of ten years.

In February 2004, under the 2003 Plan, 383,000 shares were issued to employees and directors of the Company in the form of bonus and restricted stock awards. The Company recorded \$1,915,000 of compensation expense in February 2004 related to the issuance of 127,667 shares (bonus stock awards) valued at \$15.00 per share that were fully vested on the date of grant. Compensation related to the 255,333 restricted shares will be accrued over the next two years. The restricted shares will vest on each of the first and second anniversaries of the grant date.

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## CHENIERE ENERGY, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table includes the pro forma effects as of December 31, 2003 of Cheniere's common stock issued pursuant to the private placement in January 2004, common stock issued upon warrant and stock option exercises in January and February 2004, the repayment of the Company's note payable in January 2004 and the reimbursement from limited partnership investment in January 2004:

|   | Unaudited            |                       |               |                      |
|---|----------------------|-----------------------|---------------|----------------------|
|   | Historical           | Pro Forma Adjustments |               | Pro Forma            |
|   | Historical           | Debits                | Credits       | Pro Forma            |
| Current Assets                                    | \$ 4,487,352         | 13,884,750(1)         | 1,000,000(2)  | \$ 21,181,661        |
|   |                      | 922,059(3)            |               |                      |
|   |                      | 387,500(4)            |               |                      |
|   |                      | 2,500,000(5)          |               |                      |
| Oil and Gas Properties                            | 19,134,954           |                       |               | 19,134,954           |
| LNG Site Costs                                    | 310,500              |                       |               | 310,500              |
| Other   | 657,951              |                       |               | 657,951              |
| <b>Total Assets</b>                               | <b>\$ 24,590,757</b> |                       |               | <b>\$ 41,285,066</b> |
| Current Liabilities                               | \$ 4,331,826         | 1,000,000(2)          |               | \$ 3,331,826         |
| Deferred Revenue                                  | 1,000,000            |                       |               | 1,000,000            |
| Minority Interest                                 | 120,032              |                       |               | 120,032              |
| Stockholders' Equity                              |                      |                       |               |                      |
| Common Stock                                      | 49,465               |                       | 3,300(1)      | 54,831               |
|   |                      |                       | 1,811(3)      |                      |
|   |                      |                       | 255(4)        |                      |
| Additional Paid-in-Capital                        | 48,034,244           |                       | 13,881,450(1) | 63,223,187           |
|   |                      |                       | 920,248(3)    |                      |
|   |                      |                       | 387,245(4)    |                      |
| Accumulated Deficit                               | (28,944,810)         |                       | 2,500,000(5)  | (26,444,810)         |
| <b>Total Stockholders' Equity</b>                 | <b>19,138,899</b>    |                       |               | <b>36,833,208</b>    |
| <b>Total Liabilities and Stockholders' Equity</b> | <b>\$ 24,590,757</b> |                       |               | <b>\$ 41,285,066</b> |

The pro forma adjustments include the following items:

- (1) Issuance of 1,100,000 shares of common stock in a private placement, net of offering costs
- (2) Repayment of \$1,000,000 outstanding balance in notes payable



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- (3) Issuance of common stock pursuant to exercise of options to purchase common stock
- (4) Issuance of common stock pursuant to exercise of warrants to purchase common stock
- (5) Cash reimbursement received after Cheniere's investment in Freeport LNG was reduced to zero.

**Table of Contents****CHENIERE ENERGY, INC. AND SUBSIDIARIES****SUPPLEMENTAL INFORMATION TO CONSOLIDATED FINANCIAL STATEMENTS****OIL AND GAS RESERVES AND RELATED FINANCIAL DATA**

(unaudited)

**Costs Incurred in Oil and Gas Producing Activities**

Presented below are costs incurred in oil and gas property acquisition, exploration and development activities:

|   | Year Ended December 31, |                     |                     |
|---|-------------------------|---------------------|---------------------|
|   | 2003                    | 2002                | 2001                |
| Acquisition of properties                         |                         |                     |                     |
| Proved properties                                 | \$                      | \$                  | \$                  |
| Unproved properties                               | 936,814                 | 130,822             | 1,899,154           |
| Exploration costs                                 | 1,577,543               | 2,682,548           | 2,908,654           |
| Development costs                                 |                         | 15,011              | 99,800              |
| <b>Total</b>                                      | <b>\$ 2,514,357</b>     | <b>\$ 2,828,381</b> | <b>\$ 4,907,608</b> |
| Proportional share of unconsolidated affiliate(1) |                         | \$ 43,496,000       | \$ 36,576,000       |

- (1) Effective January 1, 2003, Cheniere began accounting for its investment in Gryphon using the cost method of accounting. Prior to that time, Cheniere accounted for this investment using the equity method of accounting. Accordingly, the amounts for 2002 and 2001 represent Cheniere's proportional share, based on its 100% common stock ownership, of the costs incurred in oil and gas activities of Gryphon. Upon the conversion of Gryphon's preferred shares, such proportional share of Gryphon activities would be reduced to 9.3%, or \$4,045,000 for 2002.

Included in the above amounts for the years ended December 31, 2003, 2002 and 2001 were \$1,063,996, \$849,240 and \$947,813, respectively, of capitalized general and administrative expenses, capitalized interest expense and capitalized debt discount directly related to property acquisition, exploration and development.

**Capitalized Costs Related to Oil and Gas Producing Activities**

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The following table presents total capitalized costs of proved and unproved properties and accumulated depreciation, depletion and amortization related to oil and gas producing operations:

|  | <b>December 31,</b> |               |
|--|---------------------|---------------|
|  | <b>2003</b>         | <b>2002</b>   |
| Proved properties                                    | \$ 1,223,020        | \$ 857,388    |
| Unproved properties                                  | 18,047,802          | 16,751,347    |
|  | 19,270,822          | 17,608,735    |
| Accumulated depreciation, depletion and amortization | (135,868)           | (14,506)      |
|  | \$ 19,134,954       | \$ 17,594,229 |
| Proportional share of unconsolidated affiliate(1)    |                     | \$ 89,698,000 |

- (1) Effective January 1, 2003, Cheniere began accounting for its investment in Gryphon using the cost method of accounting. Prior to that time, Cheniere accounted for this investment using the equity method of accounting. Accordingly, the amount for 2002 represents Cheniere's proportional share, based on its 100% common stock ownership, of the capitalized costs related to oil and gas producing activities of Gryphon. Upon the conversion of Gryphon's preferred shares, such proportional share of Gryphon's capitalized costs related to oil and gas producing activities would be reduced to 9.3%, or \$8,342,000 at December 31, 2002.

**Table of Contents****CHENIERE ENERGY, INC. AND SUBSIDIARIES****SUPPLEMENTAL INFORMATION TO CONSOLIDATED FINANCIAL STATEMENTS****OIL AND GAS RESERVES AND RELATED FINANCIAL DATA (Continued)**

(unaudited)

**Results of Operations from Oil and Gas Producing Activities**

The results of operations from oil and gas producing activities are as follows:

|  | <b>Year Ended December 31,</b> |             |                |
|--|--------------------------------|-------------|----------------|
|  | <b>2003</b>                    | <b>2002</b> | <b>2001</b>    |
| Revenues   | \$ 657,467                     | \$ 239,055  | \$ 2,372,632   |
| Production Costs   |                                | (90,038)    | (420,242)      |
| Depreciation, depletion and amortization   | (121,362)                      | (74,566)    | (1,029,239)    |
| Ceiling test write-down  |                                |             | (5,126,248)    |
| Income tax benefit (expense)   |                                |             |                |
| Results of operations from oil and gas producing activities (excluding corporate overhead and interest costs)  | \$ 536,105                     | \$ 74,451   | \$ (4,203,097) |
| Equity in results of operations from oil and gas producing activities (excluding corporate overhead and interest costs) of unconsolidated affiliate(1) |                                | \$ 828,000  | \$ 907,000     |

- (1) Effective January 1, 2003, Cheniere began accounting for its investment in Gryphon using the cost method of accounting. Prior to that time, Cheniere accounted for this investment using the equity method of accounting. Accordingly, the amounts for 2002 and 2001 represent Cheniere's proportional share, based on its 100% common stock ownership, of the results of operations from oil and gas producing activities (excluding corporate overhead and interest costs). Such proportional share will be reduced to 9.3% upon the conversion of Gryphon's preferred shares, resulting in a decrease in Cheniere's proportional interest in the results of operations from oil and gas producing activities to \$77,000 for 2002.

**Reserve Quantities**

Estimates of proved reserves of Cheniere and the related standardized measure of discounted future net cash flow information are based on the reports generated by the Company's independent petroleum engineers, Sharp Petroleum Engineering, Inc. in 2003 and Ryder Scott Company in 2001 and substantially, but not wholly, based on the report generated by Ryder Scott Company in 2002, in accordance with the rules and regulations of the SEC. The independent engineers' estimates were based upon a review of production histories and other geologic, economic, ownership and engineering data provided by the Company. These estimates represent the Company's interest in the reserves associated with its

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properties. All of the Company's oil and gas reserves are located within the United States or its territorial waters.

The Company's estimates of its proved reserves and proved developed reserves of oil and gas as of December 31, 2003, 2002 and 2001 and the changes in its proved reserves are as follows:

|   | 2003          |                | 2002          |                  | 2001          |                  |
|---|---------------|----------------|---------------|------------------|---------------|------------------|
|   | Oil<br>(Bbls) | Gas<br>(Mcf)   | Oil<br>(Bbls) | Gas<br>(Mcf)     | Oil<br>(Bbls) | Gas<br>(Mcf)     |
| <b>Proved reserves:</b>   |               |                |               |                  |               |                  |
| Beginning of year   | 3,980         | 1,333,000      | 15,088        | 3,245,000        | 19,874        | 4,568,000        |
| Revisions of prior estimates  | (3,830)       | (1,093,920)    |               |                  | (2,178)       | (780,226)        |
| Production  | (17)          | (123,392)      | (495)         | (91,470)         | (2,608)       | (542,774)        |
| Sale of reserves in place   |               |                | (14,598)      | (3,177,278)      |               |                  |
| Extensions, discoveries and other additions   | 4,990         | 797,091        | 3,985         | 1,356,748        |               |                  |
| <b>End of year</b>  | <b>5,123</b>  | <b>912,779</b> | <b>3,980</b>  | <b>1,333,000</b> | <b>15,088</b> | <b>3,245,000</b> |
| <b>Interest in proved reserves of unconsolidated affiliate end of year(1)</b>           |               |                |               |                  |               |                  |
|   |               |                | 371,808       | 27,508,000       | 210,151       | 17,468,000       |
| <b>Proved developed reserves:</b>   |               |                |               |                  |               |                  |
| Beginning of year   | 1,606         | 503,000        | 15,088        | 3,245,000        | 16,913        | 3,982,000        |
| <b>End of year</b>  | <b>3,024</b>  | <b>759,095</b> | <b>1,606</b>  | <b>503,000</b>   | <b>15,088</b> | <b>3,245,000</b> |
| <b>Interest in proved developed reserves of unconsolidated affiliate end of year(1)</b> |               |                |               |                  |               |                  |
|   |               |                | 165,421       | 16,332,000       | 192,569       | 13,022,000       |

(1) Effective January 1, 2003, Cheniere began accounting for its investment in Gryphon using the cost method of accounting. Prior to that time, Cheniere accounted for this investment using the equity method of accounting. Accordingly, the amounts for 2002

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**CHENIERE ENERGY, INC. AND SUBSIDIARIES**

**SUPPLEMENTAL INFORMATION TO CONSOLIDATED FINANCIAL STATEMENTS**

**OIL AND GAS RESERVES AND RELATED FINANCIAL DATA (Continued)**

(unaudited)

and 2001 represent Cheniere's proportional share, based on its 100% common stock ownership, of the proved reserves and proved developed reserves of Gryphon. Upon the conversion of Gryphon's preferred shares, such proportional share of Gryphon reserves would be reduced to 9.3%, or proved reserves of 34,578 Bbls and 2,558,000 Mcf and proved developed reserves of 15,384 Bbls and 1,519,000 Mcf at December 31, 2002. Such reserves were not considered in the Company's calculation of depreciation, depletion and amortization or the calculation of its ceiling test.

There are numerous uncertainties inherent in estimating quantities of proved reserves and in projecting future rates of production and future amounts and timing of development expenditures, including many factors beyond the control of the Company. Reserve engineering is a subjective process of estimating underground accumulations of crude oil and natural gas that cannot be measured in an exact manner, and the accuracy of any reserve estimate is a function of the quality of available data and of engineering and geological interpretation and judgment. Estimates of proved undeveloped reserves are inherently less certain than estimates of proved developed reserves. The quantities of oil and gas that are ultimately recovered, production and operating costs, the amount and timing of future development expenditures, geologic success and future oil and gas sales prices may all differ from those assumed in these estimates. In addition, the Company's reserves may be subject to downward or upward revision based upon production history, purchases or sales of properties, results of future development, prevailing oil and gas prices and other factors.

**Standard Measure of Discounted Future Net Cash Flows**

The standardized measure of discounted future net cash flows was calculated by applying year-end prices (adjusted for location and quality differentials) to estimated future production, less future expenditures (based on year-end costs) to be incurred in developing and producing the Company's proved reserves and the estimated effect of future income taxes based on the current tax law. The resulting future net cash flows were discounted using a rate of 10% per annum.

The standardized measure of discounted future net cash flow amounts contained in the following tabulation does not purport to represent the fair market value of oil and gas properties. No value has been given to unproved properties. There are significant uncertainties inherent in estimating quantities of proved reserves and in projecting rates of production and the timing and amount of future costs. Future realization of oil and gas prices over the remaining reserve lives may vary significantly from current prices. In addition, the method of valuation utilized, based on year-end prices and costs and the use of a 10% discount rate, is not necessarily appropriate for determining fair value.

The standardized measure of discounted future net cash flows relating to proved oil and gas reserves is as follows:

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|   | December 31, |              |              |
|---|--------------|--------------|--------------|
|   | 2003         | 2002         | 2001         |
| Future gross revenues                                       | \$ 5,231,382 | \$ 6,343,537 | \$ 8,076,063 |
| Less future costs:  |              |              |              |
| Production  | (134,251)    | (163,683)    | (2,570,550)  |
| Development   |              | (56,250)     | (910,800)    |
| Income Taxes  |              |              |              |
| Future net cash flows                                       | 5,097,131    | 6,123,604    | 4,594,713    |
| Less 10% annual discount for estimated timing of cash flows | (819,396)    | (992,141)    | (1,671,812)  |
| Standardized measure of discounted future net cash flows    | \$ 4,277,735 | \$ 5,131,463 | \$ 2,922,901 |

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## CHENIERE ENERGY, INC. AND SUBSIDIARIES

## SUPPLEMENTAL INFORMATION TO CONSOLIDATED FINANCIAL STATEMENTS

## OIL AND GAS RESERVES AND RELATED FINANCIAL DATA (Continued)

(unaudited)

The following table summarizes the principal sources of change in the standardized measure of discounted future net cash flows:

|   | Year Ended December 31, |               |               |
|---|-------------------------|---------------|---------------|
|   | 2003                    | 2002          | 2001          |
| Standardized measure beginning of period  | \$ 5,131,463            | \$ 2,922,901  | \$ 20,618,002 |
| Sales of oil and gas produced, net of production costs  | (657,467)               | (149,017)     | (1,952,390)   |
| Extensions, discoveries and other additions   | 3,691,594               | 5,208,984     |               |
| Revisions to previous quantity estimates, timing and other  | (4,944,824)             | (28,799)      | (675,047)     |
| Net changes in prices and production costs  | 726,671                 |               | (21,242,047)  |
| Sale of reserves in place   |                         | (2,212,670)   |               |
| Development costs incurred  |                         | 15,011        | 99,800        |
| Changes in estimated development costs  |                         | (624,947)     | (1,556,205)   |
| Net changes in income taxes   |                         |               | 5,062,716     |
| Accretion of discount   | 330,298                 |               | 2,568,072     |
| Standardized measure end of period  | \$ 4,277,735            | \$ 5,131,463  | \$ 2,922,901  |
| Standardized measure end of period proportional interest in reserves of unconsolidated affiliate(1) |                         | \$ 95,211,000 | \$ 28,778,000 |
| Current prices at year-end, used in standardized measure  |                         |               |               |
| Oil (per Bbl)   | \$ 31.00                | \$ 29.23      | \$ 19.00      |
| Gas (per Mcf)   | 5.63                    | 4.64          | 2.61          |

- (1) Effective January 1, 2003, Cheniere began accounting for its investment in Gryphon using the cost method of accounting. Prior to that time, Cheniere accounted for this investment using the equity method of accounting. Accordingly, the amounts for 2002 and 2001 represent Cheniere's proportional share, based on its 100% common stock ownership, of the standardized measure of Gryphon's proved oil and gas reserves. Such proportional share of Gryphon's standardized measure will be reduced to 9.3% upon the conversion of Gryphon's preferred shares, resulting in a decrease in Cheniere's proportional interest in the standardized measure of unconsolidated affiliate to \$8,855,000 at December 31, 2002.

The Company may receive amounts different than those incorporated into the standardized measure of discounted cash flow for a number of reasons, including changes in prices. Therefore, the present value shown above should not be construed as the current market value of the estimated oil and gas reserves attributable to the Company's properties.





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(unaudited)

**Quarterly Financial Data (unaudited)**

|   | <b>First</b>   | <b>Second</b>  | <b>Third</b>   | <b>Fourth</b>  | <b>Year</b> |
|---|----------------|----------------|----------------|----------------|-------------|
|   | <b>Quarter</b> | <b>Quarter</b> | <b>Quarter</b> | <b>Quarter</b> | <b>Year</b> |
| <b>Year ended December 31, 2003:</b>          |                |                |                |                |             |
| Revenues                                      | \$ 110,120     | \$ 121,300     | \$ 135,245     | \$ 290,802     | \$ 657,467  |
| Gross profit(1)                               | 51,428         | 29,989         | 34,242         | 113,128        | 228,787     |
| Income (loss) from operations                 | (862,744)      | (1,185,749)    | (2,924,546)    | (4,045,111)    | (9,018,150) |
| Net income (loss)(3)                          | 3,121,309      | (1,624,242)    | (2,387,021)    | (4,398,063)    | (5,288,017) |
| Net income (loss) per share basic and diluted | \$ 0.23        | \$ (0.11)      | \$ (0.16)      | \$ (0.27)      | \$ (0.36)   |
| <b>Year ended December 31, 2002:</b>          |                |                |                |                |             |
| Revenues                                      | \$ 161,604     | \$ 37,955      | \$ 21,998      | \$ 17,498      | \$ 239,055  |
| Gross profit(1)                               | (18,423)       | (52,528)       | (111,912)      | (36,682)       | (219,545)   |
| Income (loss) from operations(2)              | (1,318,501)    | (1,636,668)    | (1,478,002)    | 738,264        | (3,694,907) |
| Net income (loss)(2)                          | (2,530,967)    | (2,366,029)    | (1,474,972)    | 739,660        | (5,632,308) |
| Net loss per share basic and diluted          | \$ (0.19)      | \$ (0.18)      | \$ (0.11)      | \$ 0.06        | \$ (0.42)   |

(1) Revenues less operating expenses other than general and administrative.

(2) Fourth quarter 2002 includes \$1,740,426 in recoveries of general and administrative expenses reimbursable under the terms of an agreement related to Cheniere's sale of its Freeport LNG site, which closed in February 2003.

(3) The first quarter of 2003 includes \$4,760,000 and \$423,454 in gains, respectively, on sales of 60% of the Freeport LNG terminal project to Freeport LNG and a 10% limited partner interest in Freeport LNG to a third party. See Note 7 to the Consolidated Financial Statements.

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**PART IV**

**Item 15. Exhibits, Financial Statement Schedules and Reports on Form 8-K**

(a) Financial Statements, Schedules and Exhibits

(3) Exhibits

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 3.1*               | Amended and Restated Certificate of Incorporation of Cheniere Energy, Inc. ( Cheniere ) (Incorporated by reference to Exhibit 4.1 of the Company s Registration Statement on Form S-8 (File No. 333-112379), filed on January 30, 2004)  |
| 3.2*               | Amended and Restated By-laws of Cheniere, as amended through January 29, 2004. (Incorporated by reference to Exhibit 4.3 of the Company s Registration Statement on Form S-8 (File No. 333-112379), filed on January 20, 2004)   |
| 4.1*               | Specimen Common Stock Certificate of Cheniere. (Incorporated by reference to Exhibit 4.1 of the Company s Registration Statement on Form S-1 (File No. 333-10905), filed on August 27, 1996)   |
| 4.2*               | Certificate of Designations, Preferences and Rights of Series A Convertible Preferred Stock of Gryphon Exploration Company. (Incorporated by reference to Exhibit 10.3 of the Company s Current Report on Form 8-K (File No. 000-09092), filed on October 20, 2000)  |
| 10.1*+             | Cheniere Energy, Inc. 1997 Stock Option Plan. (Incorporated by reference to Exhibit 10.25 of the Company s Quarterly on Form 10-Q for the quarter ended November 30, 1997 (File No. 000-09092), filed on January 14, 1998)   |
| 10.2*+             | Amendment No. 1 to Cheniere Energy, Inc. 1997 Stock Option Plan. (Incorporated by reference to Exhibit 10.27 of the Company s Annual Report on Form 10-K for the year ended December 31, 1999 (File No. 000-09092), filed on March 29, 2000)   |
| 10.3*+             | Amendment No. 2 to Cheniere Energy, Inc. 1997 Stock Option Plan. (Incorporated by reference to Exhibit 4.7 of the Company s Registration Statement on Form S-8 (File No. 333-111457), filed on December 22, 2003)  |
| 10.4*+             | Amendment No. 3 to Cheniere Energy, Inc. 1997 Stock Option Plan. (Incorporated by reference to Exhibit 8 of the Company s Registration Statement on Form S-8 (File No. 333-111457), filed on December 22, 2003)  |
| 10.5*+             | Amendment No. 4 to Cheniere Energy, Inc. 1997 Stock Option Plan. (Incorporated by reference to Exhibit 9 of the Company s Registration Statement on Form S-8 (File No. 333-111457), filed on December 22, 2003)  |
| 10.6*+             | Cheniere Energy, Inc. 2003 Stock Incentive Plan. (Incorporated by reference to Exhibit 4.5 of the Company s Registration Statement on Form S-8 (File No. 333-112379), filed on January 30, 2004)   |
| 10.7*              | Seismic Data Purchase Agreement, dated June 21, 2000 between Seitel Data Ltd. and Cheniere. (Incorporated by reference to Exhibit 10.39 of the Company s Quarterly Report on Form 10-Q for the quarter ended June 30, 2000 (File No. 000-09092), filed on August 11, 2000)                                     |
| 10.8*              | Contribution and Subscription Agreement, dated as of September 15, 2000, by and among the Company, Gryphon Exploration Company and the other investors listed therein. (Incorporated by reference to Exhibit 10.1 of the Company s Current Report on Form 8-K (File No. 000-09092), filed on October 20, 2000) |
| 10.9*              | Stockholders Agreement, dated as of October 11, 2000. (Incorporated by reference to Exhibit 10.2 of the Company s Current Report on Form 8-K (File No. 000-09092), filed on October 20, 2000)  |
| 10.10*             |  |

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Settlement and Purchase Agreement, dated and effective as of June 14, 2001 by and between Cheniere, CXY Corporation, Crest Energy, L.L.C., Crest Investment Company and Freeport LNG Terminal, LLC.

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(Incorporated by reference to Exhibit 10.10 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2001 (File No. 001-16383), filed on April 1, 2002)

10.11\* Stock Transfer Agreement, dated March 19, 2002, by and between Gryphon Exploration Company and Cheniere. (Incorporated by reference to Exhibit 10.11 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2001 (File No. 001-16383) filed on April 1, 2002)

10.12\* Contribution Agreement, dated as of August 26, 2002, by and among Freeport LNG Investments, LLC, Freeport LNG-GP, Inc., Cheniere, Cheniere LNG, Inc. and Freeport LNG Terminal, LLC. (Incorporated by reference to Exhibit 2 of the Company's Current Report on Form 8-K (File No. 001-16383), filed on September 4, 2002)

10.13\* Extension and Amendment to Contribution Agreement, dated as of September 19, 2002, by and among Freeport LNG Investments, LLC, Freeport LNG-GP, Inc., Cheniere, Cheniere LNG, Inc. and Freeport LNG Terminal, LLC. (Incorporated by reference to Exhibit 2 of the Company's Current Report on Form 8-K (File No. 001-16383), filed on September 26, 2002)

10.14\* Second Extension and Amendment to Contribution Agreement, effective as of October 4, 2002, by and among Freeport LNG Investments, LLC, Freeport LNG-GP, Inc., Cheniere, Cheniere LNG, Inc. and Freeport LNG Terminal, LLC. (Incorporated by reference to Exhibit 1 of the Company's Current Report on Form 8-K (File No. 001-16383), filed on November 5, 2002)

10.15\* Third Amendment to Contribution Agreement, effective as of February 27, 2003, by and among Freeport LNG Investments, LLC, Freeport LNG-GP, Inc., Cheniere, Cheniere LNG, Inc. and Freeport LNG Terminal, LLC. (Incorporated by reference to Exhibit 10.4 of the Company's Current Report on Form 8-K (File No. 001-16383), filed on March 7, 2003)

10.16\* Amended and Restated Limited Partnership Agreement of Freeport LNG Development, L.P., dated as of February 27, 2003, by and among Freeport LNG-GP, Inc., Freeport LNG Investments, LLC and Cheniere LNG, Inc. (Incorporated by reference to Exhibit 10.5 of the Company's Current Report on Form 8-K (File No. 001-16383), filed on March 7, 2003)

10.17\* First Amendment to Amended and Restated Partnership Agreement of Freeport LNG Development, L.P., dated as of December 20, 2003, by and among Freeport LNG-GP, Inc., Freeport LNG Investments, LLC and Cheniere LNG, Inc. (Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K (File No. 001-16383), filed on December 19, 2003)

10.18\* Warrant to Purchase Common Stock, dated as of February 27, 2003, issued by Cheniere in favor of Freeport LNG Investments, LLC. (Incorporated by reference to Exhibit 10.6 of the Company's Current Report on Form 8-K (File No. 001-16383), filed on March 7, 2003)

10.19\* Option Agreement, dated February 27, 2003, by and between Freeport LNG Investments, LLC and Cheniere Energy, Inc. (Incorporated by reference to Exhibit 10.7 of the Company's Current Report on Form 8-K (File No. 001-16383), filed on March 7, 2003)

10.20\* Partnership Interest Purchase Agreement, dated as of March 1, 2003, among Contango Sundance, Inc., Contango Oil & Gas, Cheniere LNG, Inc. and Cheniere. (Incorporated by reference to Exhibit 10.8 of the Company's Current Report on Form 8-K (File No. 001-16383), filed on March 7, 2003)

10.21\* Warrant to Purchase Common Stock, dated March 1, 2003, issued by Cheniere in favor of Contango Sundance, Inc. (Incorporated by reference to Exhibit 10.9 of the Company's Current Report on Form 8-K (File No. 001-16383), filed on March 7, 2003)

10.22\* Limited Partnership Agreement of Corpus Christi LNG, L.P., dated as of May 15, 2003, by and among Corpus Christ LNG-GP, Inc., BPU LNG and Cheniere. (Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K (File No. 001-16383), filed on June 11, 2003)

10.23\* Credit Agreement, dated as of July 25, 2003, by and between Cheniere, Cheniere LNG, Inc., Cheniere Energy Operating Co., Inc., Cheniere LNG Services, Inc., Cheniere-Gryphon Management, Inc. and Sterling Bank. (Incorporated by reference to Exhibit 10.1 of the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 001-16383), filed on August 13, 2003)

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|         |   |
|---------|---|
| 10.24*  | First Amendment to Credit Agreement, dated as of October 24, 2003, by and between Cheniere, Cheniere LNG, Inc., Cheniere Energy Operating Co., Inc., Cheniere LNG Services, Inc., Cheniere-Gryphon Management, Inc. and Sterling Bank. (Incorporated by reference to Exhibit 10.1 of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003 (File No. 001-16383), filed on November 13, 2003) |
| 10.25#  | Omnibus Agreement, dated as of December 20, 2003, by and among Freeport LNG Development, L.P., Freeport LNG-GP, Inc., ConocoPhillips Company (confidential treatment has been requested with respect to certain portions of this exhibit)   |
| 10.26*+ | Warrant to Purchase Common Stock, dated April 16, 2003, issued by Cheniere in favor of Charif Souki. (Incorporated by reference to Exhibit 10.2 of the Company's Quarterly Report on Form 10-Q/A (File No. 001-16383), filed on May 26, 2004)   |
| 21#     | Subsidiaries of Cheniere Energy, Inc.   |
| 23.1    | Consent of UHY Mann Frankfort Stein & Lipp CPAs, LLP  |
| 23.2    | Consent of KPMG LLP   |
| 23.3#   | Consent of Hein & Associates LLP  |
| 23.4#   | Consent of Sharp Petroleum Engineering, Inc.  |
| 23.5#   | Consent of Ryder Scott Company  |
| 31.1    | Certification by Chief Executive Officer required by Rule 13a-14(a) and 15d-14(a) under the Exchange Act  |
| 31.2    | Certification by Chief Financial Officer required by Rule 13a-14(a) and 15d-14(a) under the Exchange Act  |
| 32.1    | Certification by Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   |
| 32.2    | Certification 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   |

\* Incorporated by reference

+ Management contract or compensatory plan or arrangement

# Filed with original filing

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

CHENIERE ENERGY, INC.  
(Registrant)

By: /s/ Charif Souki

Charif Souki  
President, Chief Executive Officer and  
Chairman of the Board

Date: July 20, 2004

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| <u>Signature</u>   | <u>Title</u>  | <u>Date</u>   |
|--|---|---------------|
| <u>/s/ Charif Souki</u><br><b>Charif Souki</b>             | President, Chief Executive Officer and<br>Chairman of the Board (Principal<br>Executive Officer)    | July 20, 2004 |
| <u>/s/ Walter L. Williams</u><br><b>Walter L. Williams</b> | Vice Chairman of the Board and Director   | July 20, 2004 |
| <u>/s/ Don A. Turkleson</u><br><b>Don A. Turkleson</b>     | Vice President & Chief Financial Officer,<br>Secretary & Treasurer (Principal Financial<br>Officer) | July 20, 2004 |
| <u>/s/ Craig K. Townsend</u><br><b>Craig K. Townsend</b>   | Vice President & Controller (Principal<br>Accounting Officer)                                       | July 20, 2004 |
| <u>/s/ Nuno Brandolini</u><br><b>Nuno Brandolini</b>       | Director  | July 20, 2004 |
| <u>/s/ Keith F. Carney</u><br><b>Keith F. Carney</b>       | Director  | July 20, 2004 |
| <u>/s/ Paul J. Hoenmans</u>                                | Director  | July 20, 2004 |

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**Paul J. Hoenmans**

/s/ David B. Kilpatrick

Director

July 20, 2004

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**David B. Kilpatrick**

/s/ J. Robinson West

Director

July 20, 2004

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**J. Robinson West**



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**Gryphon Exploration Company Audited Financial Statements**

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders of

Gryphon Exploration Company:

We have audited the accompanying balance sheet of Gryphon Exploration Company, as of December 31, 2002, and the related statement of income (loss), stockholders' equity, and cash flows for each of the two years then ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Gryphon Exploration Company, as of December 31, 2002, and the results of its operations and its cash flows for each of the two years then ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America.

**KPMG LLP**

July 12, 2004

Houston, Texas

**Table of Contents****GRYPHON EXPLORATION COMPANY****BALANCE SHEET**

(dollars in thousands, except share related items)

|   | <b>December 31, 2002</b> |
|---|--------------------------|
| <b><u>ASSETS</u></b>  |                          |
| <b>CURRENT ASSETS</b>   |                          |
| Cash and Cash Equivalents   | \$ 3,246                 |
| Receivables from Joint Interest Owners and Revenue Receivables  | 3,188                    |
| Prepaid Expenses and Other  | 5,781                    |
|   | <hr/>                    |
| Total Current Assets  | 12,215                   |
| <b>OIL AND GAS PROPERTIES, full cost method</b>   |                          |
| Proved Properties, net  | 54,322                   |
| Unproved Properties, not subject to amortization  | 36,685                   |
|   | <hr/>                    |
| Total Oil and Gas Properties  | 91,007                   |
| <b>FIXED ASSETS, net</b>  | 458                      |
|   | <hr/>                    |
| Total Assets  | \$ 103,680               |
|   | <hr/>                    |
| <b><u>LIABILITIES AND STOCKHOLDERS EQUITY</u></b>   |                          |
| <b>CURRENT LIABILITIES</b>  |                          |
| Accounts Payable and Accrued Liabilities  | \$ 5,773                 |
| Advances from Joint Interest Owners   | 1,875                    |
| Revenue Payable   | 5                        |
| Short-term Note Payable   | 2,865                    |
| Hedge Liability   | 1,352                    |
|   | <hr/>                    |
| Total Current Liabilities   | 11,870                   |
|   | <hr/>                    |
| <b>DEFERRED TAX LIABILITY</b>   | 2,043                    |
| <b>COMMITMENTS AND CONTINGENCIES (NOTE 10)</b>  |                          |
| <b>STOCKHOLDERS EQUITY</b>  |                          |
| Preferred Stock, \$.01 par value Authorized: 500,000 shares; Issued and Outstanding: 85,000 shares            | 2                        |
| Common Stock, \$.01 par value Authorized: 4,000,000 shares; Issued: 145,600 shares Outstanding: 87,460 shares | 1                        |
| Additional Paid-in-Capital  | 93,160                   |
| Retained Earnings (Deficit)   | (416)                    |
| Treasury Stock  |                          |
| Recorded at cost 58,140 shares  | (2,980)                  |
|   | <hr/>                    |
| Total Stockholders Equity   | 89,767                   |
|   | <hr/>                    |
| Total Liabilities and Stockholders Equity   | \$ 103,680               |
|   | <hr/>                    |

The accompanying notes are an integral part of these financial statements.

**Table of Contents****GRYPHON EXPLORATION COMPANY****STATEMENTS OF INCOME (LOSS)**

(dollars in thousands)

|  | <b>Year ended</b>   |                   |
|--|---------------------|-------------------|
|  | <b>December 31,</b> |                   |
|  | <b>2002</b>         | <b>2001</b>       |
|  | <u>          </u>   | <u>          </u> |
| Oil and Gas Revenue  | \$ 12,495           | \$ 2,382          |
| Loss on Derivative Instruments                               | (1,352)             | <u>          </u> |
|  | <u>11,143</u>       | <u>2,382</u>      |
| <b>Operating Costs and Expenses</b>                          |                     |                   |
| Production Costs   | 804                 | 254               |
| Workover Costs   | 3,226               |                   |
| Depreciation, Depletion and Amortization                     | 6,521               | 1,769             |
| General and Administrative Expenses                          | 1,423               | 685               |
|  | <u>11,974</u>       | <u>2,708</u>      |
| Loss From Operations Before Interest Income and Income Taxes | (831)               | (326)             |
| Interest Income  | 157                 | 408               |
|  | <u>          </u>   | <u>          </u> |
| Income (Loss) From Operations Before Income Taxes            | (674)               | 82                |
| Income Tax Benefit   | 155                 | 2                 |
|  | <u>          </u>   | <u>          </u> |
| Net Income (Loss)  | <u>\$ (519)</u>     | <u>\$ 84</u>      |

The accompanying notes are an integral part of these financial statements

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## GRYPHON EXPLORATION COMPANY

## STATEMENTS OF STOCKHOLDERS EQUITY

(dollars in thousands)

|                             | Common Stock |        | Preferred Stock |        | Additional         | Retained | Treasury   | Total                  |
|-----------------------------|--------------|--------|-----------------|--------|--------------------|----------|------------|------------------------|
|                             | Shares       | Amount | Shares          | Amount | Paid-In<br>Capital | Earnings | Stock      | Stockholders<br>Equity |
| Balance December 31, 2000   | 145,600      | \$ 1   | 25,000          | \$     | \$ 33,168          | \$ 19    | \$         | \$ 33,188              |
| Treasury Stock              | (6,740)      |        |                 |        |                    |          | (418)      | (418)                  |
| Issuance of Preferred Stock |              |        | 30,000          | 1      | 29,999             |          |            | 30,000                 |
| Offering Costs              |              |        |                 |        | (6)                |          |            | (6)                    |
| Net Income                  |              |        |                 |        |                    | 84       |            | 84                     |
| Balance December 31, 2001   | 138,860      | \$ 1   | 55,000          | \$ 1   | \$ 63,161          | \$ 103   | \$ (418)   | \$ 62,848              |
| Treasury Stock              | (51,400)     |        |                 |        |                    |          | (2,562)    | (2,562)                |
| Issuance of Preferred Stock |              |        | 30,000          | 1      | 29,999             |          |            | 30,000                 |
| Net Loss                    |              |        |                 |        |                    | (519)    |            | (519)                  |
| Balance December 31, 2002   | 87,460       | \$ 1   | 85,000          | \$ 2   | \$ 93,160          | \$ (416) | \$ (2,980) | \$ 89,767              |

The accompanying notes are an integral part of these financial statements.

**Table of Contents****GRYPHON EXPLORATION COMPANY****STATEMENTS OF CASH FLOWS**

(dollars in thousands)

|  | Year ended      |                 |
|--|-----------------|-----------------|
|  | December 31,    |                 |
|  | 2002            | 2001            |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                 |                 |
| Net Income (Loss)  | \$ (519)        | \$ 84           |
| Adjustments to Reconcile Net Income (Loss) to Net Cash Provided by Operating Activities: |                 |                 |
| Depreciation, Depletion and Amortization   | 6,521           | 1,769           |
| Loss on Derivative Instruments   | 1,352           |                 |
| Deferred Income Taxes  | 862             | (2)             |
| Changes in Operating Assets and Liabilities  |                 |                 |
| Restricted Cash Deposits   |                 | 9,425           |
| Accounts Receivable  | (1,869)         | (246)           |
| Prepaid Expenses   | (1,920)         | (3,084)         |
| Accounts Payable and Current Liabilities   | 5,517           | (6,123)         |
| <b>NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES</b>                               | <b>9,944</b>    | <b>1,823</b>    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                 |                 |
| Oil and Gas Property Additions   | (43,495)        | (36,599)        |
| Purchases of Fixed Assets  | (323)           | (512)           |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>   | <b>(43,818)</b> | <b>(37,111)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |                 |                 |
| Sale of Preferred Stock  | 30,000          | 30,000          |
| Purchase of Treasury Stock   | (2,562)         | (418)           |
| Offering Costs   |                 | (6)             |
| Proceeds from borrowings   |                 | 1,804           |
| Repayment of borrowings  |                 | (716)           |
| <b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>   | <b>27,438</b>   | <b>30,664</b>   |
| <b>NET DECREASE IN CASH</b>  | <b>(6,436)</b>  | <b>(4,624)</b>  |
| <b>CASH BEGINNING OF PERIOD</b>  | <b>9,683</b>    | <b>14,307</b>   |
| <b>CASH END OF PERIOD</b>  | <b>\$ 3,247</b> | <b>\$ 9,683</b> |

The accompanying notes are an integral part of these financial statements.





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**GRYPHON EXPLORATION COMPANY**

**NOTES TO FINANCIAL STATEMENTS**

(dollars in thousands, except share related items)

**NOTE 1 Organization and Nature of Operations**

Gryphon Exploration Company, a Delaware corporation, ( "Gryphon" or the "Company" ) is a Houston-based company formed for the purpose of oil and gas exploration, development and exploitation. The Company is currently engaged in the exploration and production for oil and natural gas in the Gulf of Mexico. The Company began operations October 2000.

On October 11, 2000 ( "Inception" ), Gryphon completed a transaction with Warburg, Pincus Equity Partners, L.P. and certain affiliates thereof, ( "Warburg" ) a global private equity fund based in New York, and Cheniere Energy, Inc. ( "Cheniere" ) to fund an exploration program based upon approximately 8,800 square miles of 3D seismic data in the Gulf of Mexico (the "Fairfield" data set ). Cheniere contributed selected net assets in exchange for 100% of the common stock of Gryphon. These assets included the Fairfield data set license, certain offshore leases, a prospect then being drilled, an exploration agreement with an industry partner (described in Note 4) and certain other assets and liabilities. In addition, Gryphon assumed certain liabilities and obligations of Cheniere in connection with the contribution of assets. The assets received from Cheniere less the liabilities assumed were recorded at their estimated net fair value at the date of the transaction. Also, at inception, Warburg contributed \$25,000 and received Gryphon Series A convertible preferred stock, with an 8% cumulative dividend (Series A preferred stock). Cheniere and Warburg also agreed, under certain circumstances, to contribute additional capital up to \$75,000 to Gryphon, proportionate to their respective ownership interests.

As further discussed in Note 6, Warburg and certain employees of the Company contributed an additional \$60,000 in exchange for 60,000 shares of Series A preferred stock during 2001 and 2002.

**NOTE 2 Summary of Significant Accounting Policies**

**Basis of Presentation**

The financial statements include the accounts of Gryphon Exploration Company. As an independent oil and gas producer, the Company's revenue, profitability and future rate of growth are substantially dependent upon prevailing prices for natural gas, oil and condensate, which are dependent upon numerous factors beyond the Company's control, such as economic, political and regulatory developments and competition from other sources of energy. The energy markets have historically been very volatile, and there can be no assurance that oil and gas prices will not be subject to wide fluctuations in the future. A substantial or extended decline in oil and gas prices could have a material adverse effect on the Company's financial position, results of operations, cash flows, access to capital, and on the quantities of oil and gas reserves that may be economically produced.

## Oil and Gas Properties

*General.* The Company uses the full cost method of accounting for exploration and development activities as defined by the U.S. Securities and Exchange Commission ( SEC ). Under this method of accounting, the costs for unsuccessful, as well as successful, exploration and development activities are capitalized as oil and gas properties. This includes any internal costs that are directly related to exploration and development activities. Gain or loss on the sale or other disposition of oil and gas properties is not recognized, unless the gain or loss would significantly alter the relationship between capitalized costs and proved reserves of oil and natural gas.

The sum of net capitalized costs and estimated future development and abandonment costs of oil and gas properties and mineral investments is amortized using the unit-of-production method. The carrying values of oil and gas properties included in these financial statements do not purport to represent replacement or market values.

In accordance with SEC Regulation S-X Rule 410 a(2), proved oil and gas reserves are the estimated quantities of natural gas, crude oil, condensate, and natural gas liquids that geological and engineering data demonstrate with reasonable certainty can be recovered in future years from new reservoirs under existing economic and operating conditions. Reserves are considered proved if they can be produced economically as demonstrated by either actual production or conclusive formation tests. The Company emphasizes that the volumes of reserves are estimates which, by their nature, are subject to revision. The estimates are made using all available geological and reservoir data, as well as production performance data. These estimates, made by the Company's engineers and an independent third party reservoir engineering firm, are reviewed and revised, either upward or downward, as warranted by additional data. Revisions are necessary due to changes in assumptions based upon, among other things, reservoir performance, prices, economic conditions and governmental restrictions. Decreases in prices, for example, may cause a reduction in some proved reserves due to uneconomic conditions.

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**GRYPHON EXPLORATION COMPANY**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

(dollars in thousands, except share related items)

*Unproved Oil and Gas Properties.* Unproved oil and gas properties include costs that are excluded from proved oil and gas properties and are not subject to amortization. These amounts generally represent costs of investments in unproved properties, non-producing leases, seismic data sets, and major development projects. Gryphon excludes these costs until proved reserves are found or it is determined that the costs are impaired. All costs excluded are reviewed at least annually to determine if impairment has occurred. Any impairment is transferred to the costs to be amortized (the proved oil and gas property pool). The Company evaluates significant properties, composed primarily of costs associated with offshore leases and seismic data sets, at least annually. Non-producing leases are evaluated based on the progress of the Company's exploration program to date. Exploration costs are transferred from unproved oil and gas properties to proved oil and gas properties upon completion the first exploratory well on each property.

*Capitalized Seismic Costs / General & Administrative Expenses.* The Company capitalizes the costs associated with its 3D data sets as well as a portion of its General and Administrative expenses which are applicable to its exploration activities. As the direct costs associated with drilled properties are transferred from the Company's unproved oil and gas properties to its proved oil and gas properties, the Company allocates a portion of the capitalized 3D seismic and General and Administrative expense to the proved property pool. The Company's allocation of these costs is based upon the capitalized costs associated with each 3D data set area divided by the estimated number of prospects projected to be developed from each respective data set. During 2002 and 2001, respectively, the Company allocated approximately \$3,400 and \$1,800 of seismic exploration cost, general and administrative, and other costs transferred by Cheniere at Inception, to the cost of proved properties based on this allocation method. It is reasonably possible, based on the results obtained from future drilling, that revisions to this estimate could occur in the future, which could affect the Company's capitalization ceiling.

*Capitalized Interest.* SFAS No. 34, Capitalization of Interest Costs, provides standards for the capitalization of interest costs as part of the historical cost of acquiring assets. Financial Accounting Standards Board Interpretation (FIN) No. 33 provides guidance for the application of SFAS No. 34 to the full cost method of accounting for oil and gas properties. Under FIN No. 33, costs of investments in unproved properties and major development projects, which are not subject to amortization and on which exploration or development activities are in progress, qualify for capitalization of interest. Capitalized interest is calculated by multiplying the Company's weighted-average interest rate on debt by the amount of costs included in unproved oil and gas properties. Capitalized interest cannot exceed gross interest expense. As costs are transferred from the unproved oil and gas properties pool to the proved oil and gas properties pool, the associated capitalized interest is also transferred to the proved oil and gas properties pool. The Company incurred no interest expense during in 2002 or 2001, thus no interest costs were capitalized during those periods.

*Ceiling Test.* The Company limits the capitalized costs of proved oil and gas properties, net of accumulated Depreciation, Depletion, and Amortization (DD&A) and the related deferred income taxes, to the estimated future net cash flows from proved oil and gas reserves, using prices in effect at the end of the applicable reporting period held flat for the life of production, discounted at 10%, net of related tax effects. If capitalized costs exceed this limit, the excess is charged to expense and reflected as additional DD&A.

**Revenue Recognition**

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Revenues from the sale of oil and gas produced are recognized upon passage of title, net of royalty interests. When sales volumes differ from the Company's entitled share, an overproduced or underproduced imbalance occurs. To the extent the overproduced imbalance exceeds the Company's share of the remaining estimated proved natural gas reserves for a given property, the Company records a liability. At December 31, 2002 and 2001, the Company had no material gas imbalances.

### **Reimbursable expenses**

The Company performs administrative services on behalf of third parties in accordance with certain contractual arrangements. The Company was reimbursed \$810 and \$449 during 2002 and 2001, respectively, related to these services. These reimbursements are offset against general and administrative expenses of the Company.

### **Prepaid expenses**

Prepaid expenses at December 31, 2002 and 2001 consist of prepaid insurance premiums of \$4,093 and \$1,850, respectively, as well as other prepaid expenses.

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**GRYPHON EXPLORATION COMPANY**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

(dollars in thousands, except share related items)

**Fixed Assets**

Fixed assets are recorded at cost. Repairs and maintenance costs are charged to operations as incurred. Depreciation is computed using the straight-line method calculated to amortize the cost of assets over their estimated remaining useful lives, which are estimated as 9 to 36 months for software and computer equipment and 1 to 5 years for office furnishings. Leasehold improvements are amortized over the term of the underlying lease. Upon retirement or other disposition of property and equipment, the cost and related depreciation is removed from the accounts and the resulting gains or losses are recorded.

**Income Taxes**

The Company utilizes the liability method of accounting for income taxes, as set forth in Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. Under the liability method, deferred taxes are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse. Valuation allowances are recorded against deferred tax assets when it is considered more likely than not that the deferred tax assets will not be utilized.

**Stock-Based Compensation**

SFAS No. 123, Accounting for Stock-Based Compensation, encourages, but does not require, companies to record compensation cost for stock-based employee compensation plans at fair value. The Company has chosen to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ), and related interpretations. Accordingly, compensation cost for stock options is measured as the excess, if any, of the market price of the Company's stock at the date of the grant over the amount an employee must pay to acquire the stock. The Company grants options at or above the market price of its common stock at the date of each grant.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure, an amendment of FASB Statement No. 123*. This statement amends FASB Statement No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement No. 123 to require prominent disclosures in both annual and interim financial statements. Certain of the disclosure modifications are required for fiscal years ending after December 15, 2002 and are included in the notes to these consolidated financial statements.

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The fair value of options is calculated using the Black-Scholes option-pricing model. Assumptions used for 2002 and 2001 were: no dividend yield, no volatility, risk-free interest rate of 4.3% and 3.8%, respectively, and an expected average option life of 5 years. If the Company had adopted the recognition provisions of SFAS No. 123 for 2002 and 2001, the Company's financial statements would have not reflected a change in reported net income.

### **Cash Equivalents**

The Company classifies all investments with original maturities of three months or less as cash equivalents.

### **Fair Value of Financial Instruments**

The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable, and short-term debt approximate fair value because of the short maturities of those instruments.

### **Derivative Instruments**

On January 1, 2001, the Company adopted SFAS No. 133, *Accounting for Derivative Instruments and Certain Hedging Activities* and SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activity, an Amendment of SFAS 133*. SFAS Nos. 133 and 138 require that all derivative instruments be recorded on the balance sheet at their respective fair values. See Note 6 for information regarding the Company's derivative instruments and hedging activities.

### **Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ from those estimates. Changes in such estimates may affect amounts reported in future periods.

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**GRYPHON EXPLORATION COMPANY**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

(dollars in thousands, except share related items)

**Concentration of Credit Risk**

The Company maintains cash balances with a bank and frequently exceeds federally insured limits. The Company invests its cash in money market securities, investment grade commercial paper, and U.S. Government-backed securities. The Company's joint interest partners consist primarily of independent oil and gas producers. The Company's oil and gas production purchasers consist primarily of independent marketers and major gas pipeline companies. The Company performs credit evaluations of its customers' financial condition and, if deemed necessary, obtains letters of credit and parental guarantees from selected customers. The Company has not experienced any significant losses from uncollectible accounts. All of the Company's derivative transactions have been carried out in the over-the-counter market.

**Environmental Liabilities**

Liabilities for loss contingencies, including environmental remediation costs, arising from claims, assessments, litigation, fines, and penalties and other sources are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated.

**Recently Issued Accounting Standards**

In June 2001, the Financial Accounting Standard Board issued the Statement of Financial Accounting Standards No. 143 ( SFAS 143 ), Accounting for Asset Retirement Obligations ( ARO ), which requires that an asset retirement cost be capitalized as part of the cost of the related long-lived asset and allocated to expense by using a systematic and rational method. Under this Statement, an entity is not required to re-measure an ARO liability at fair value each period but is required to recognize changes in an ARO liability resulting from the passage of time and revisions in cash flow estimates. This Statement is effective for financial statements issued for fiscal years beginning after June 15, 2002. The Company expects to adopt SFAS 143 on January 1, 2003. The Company has not yet determined the impact that the adoption of SFAS 143 will have on its earnings or statement of financial position.

In October 2001, the Financial Accounting Standard Board issued the Statement of Financial Accounting Standards No. 144 ( SFAS 144 ), Accounting for the Impairment or Disposal of Long-Lived Assets . The Statement requires that long-lived assets that are to be disposed of by sale be measured at lower of book value or fair value less cost of sale. The Statement also expanded the scope of discontinued operations to include all components of an entity with operations that can be distinguished from the rest of the entity and that will be eliminated from the ongoing operations of the entity in a disposal transaction. The provisions of this Statement are effective for fiscal years beginning after December 15, 2001. The provisions of this Statement will impact any asset dispositions the Company makes after January 1, 2002.

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In April 2002, the FASB issued SFAS No. 145, *Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections*. SFAS No. 145 amends existing guidance on reporting gains and losses on the extinguishment of debt to prohibit the classification of the gain or loss as extraordinary, as the use of such extinguishments have become part of the risk management strategy of many companies. SFAS No. 145 also amends SFAS No. 13 to require sale-leaseback accounting for certain lease modifications that have economic effects similar to sale-leaseback transactions. The provisions of the Statement related to the rescission of Statement No. 4 are applied in fiscal years beginning after May 15, 2002. Earlier application of these provisions is encouraged. The provisions of the Statement related to Statement No. 13 were effective for transactions occurring after May 15, 2002, with early application encouraged. The adoption of SFAS No. 145 is not expected to have a material effect on the Company's financial statements.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity*. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. The adoption of SFAS No. 146 is not expected to have a material effect on the Company's financial statements.

In November 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others, an interpretation of FASB Statement No. 5, 57 and 107 and a rescission of FASB Interpretation No. 34*. This Interpretation elaborates on the disclosures to be made by a guarantor in its interim and



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(dollars in thousands, except share related items)

annual financial statements about its obligations under guarantees issued. The Interpretation also clarifies that a guarantor is required to recognize, at inception of a guarantee, a liability for the fair value of the obligation undertaken. The initial recognition and measurement provisions of the Interpretation are applicable to guarantees issued or modified after December 31, 2002 and are not expected to have a material effect on the Company's financial statements. The disclosure requirements are effective for financial statements of interim and annual periods ending after December 31, 2002.

In January 2003, the FASB issued Interpretation No. 46 *Consolidation of Variable Interest Entities, an interpretation of ARB No. 51*. This Interpretation addresses the consolidation by business enterprises of variable interest entities as defined in the Interpretation. The Interpretation applies immediately to variable interest in variable interest entities created after January 31, 2003, and to variable interests in variable interest entities obtained after January 31, 2003. For nonpublic enterprises, such as the Company, with a variable interest in a variable interest entity created before February 1, 2003, the Interpretation is applied to the enterprise no later than the end of the first annual reporting period beginning after June 15, 2003. The application of this Interpretation is not expected to have a material effect on the Company's financial statements. The Interpretation requires certain disclosures in financial statements issued after January 31, 2003 if it is reasonably possible that the Company will consolidate or disclose information about variable interest entities when the Interpretation becomes effective.

**NOTE 3 Fixed Assets**

Fixed assets consisted of the following:

|                                | <b>December 31,</b> |
|--------------------------------|---------------------|
|                                | <b>2002</b>         |
| Computers and Office Equipment | \$ 1,362            |
| Furniture, Fixtures and Other  | 240                 |
|                                | <u>1,602</u>        |
| Less Accumulated Depreciation  | (1,144)             |
| Fixed Assets, net              | <u>\$ 458</u>       |

**NOTE 4 Exploration Agreements**

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In 2002, Gryphon entered into an exploration agreement with an industry partner. Under the terms of the agreement, the partner acquired an option to participate at a 25% working interest level in up to seven drilling prospects generated by Gryphon in the Gulf of Mexico. During the term of the agreement, Gryphon received overhead reimbursements from this partner. In addition, Gryphon receives an increased interest in each prospect after the partner has received cumulative cash flows equal to its capital costs in each respective prospect. Gryphon is the operator of the prospects drilled pursuant to this agreement. Overhead reimbursements received under the agreement are credited as a recovery of general and administrative expenses. Total overhead reimbursements received in 2002 under this program and from other various industry partners were \$1,160.

During 2000 and 2001, the Company was party to an exploration agreement with an industry partner. Cheniere contributed this exploration agreement at Inception (see Note 1). Under the terms of the agreement, Gryphon's exploration partner acquired an option to participate at a 50% working interest level in any drilling prospect generated by Gryphon through August 2001 within a defined area of mutual interest in the Gulf of Mexico. During the term of the agreement, Gryphon received a management fee of \$230 per month from its partner. In addition, for each well drilled, Gryphon's partner pays a disproportionate share of the cost of leasing and of the initial test well on each prospect. Gryphon is the operator of the drilling program. A portion of the management fee payments was credited as a recovery of general and administrative expenses and the remaining portion reduced capitalized G&A expenses. Management fees received by Gryphon in 2001 totalled \$1,120. Certain provisions of this agreement, including those related to management fees, expired August 2001.

The Company intends to enter into one or more new industry partner agreements in 2003.

### NOTE 5 INCOME TAXES

The difference between the provision for income taxes and the amount that would be determined by applying the statutory federal income tax rate to the income or loss before income taxes is set forth below:

|   | Year ended      |               |
|---|-----------------|---------------|
|   | December 31,    |               |
|   | 2002            | 2001          |
| Federal Income Tax Expense (Benefit) at 34% | \$ (229)        | \$ 28         |
| Permanent Differences                       | 21              | 16            |
| Other                                       | 53              | (46)          |
| <b>Income Tax Provision (Benefit)</b>       | <b>\$ (155)</b> | <b>\$ (2)</b> |

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Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the carrying amounts used for income tax purposes. Deferred income taxes also reflect the net tax effects of net operating loss carryforwards. The tax effects of the Company's temporary differences and carryforwards are as follows:

|   | <b>December 31,</b> |
|---|---------------------|
|   | <b>2002</b>         |
|   | <u>          </u>   |
| Deferred Tax Assets:  |                     |
| Net Operating Loss Carryforwards  | \$ 7,529            |
|   | <u>          </u>   |
| Total Deferred Tax Assets   | 7,529               |
| Deferred Tax Liabilities:   |                     |
| Differences between Book and Tax Bases of Oil and Gas Properties, Plant and Equipment | (9,572)             |
|   | <u>          </u>   |
| Deferred Tax Liabilities, net   | \$ (2,043)          |
|   | <u>          </u>   |

There was no current income tax provision for 2002 or 2001 and no income taxes were payable during those periods.

The Company has determined that it is more likely than not that the deferred tax assets will be realized and a valuation allowance for such assets is not required.

At December 31, 2002, the Company had net operating loss (NOL) carryforwards for tax reporting purposes of approximately \$22,144, which will expire as follows:

|      |           |
|------|-----------|
| 2020 | \$ 2,170  |
| 2021 | \$ 19,251 |
| 2022 | \$ 723    |

**NOTE 6 DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

The Company produces and sells natural gas, crude oil and condensate. As a result, the Company's financial results can be significantly affected as these commodity prices fluctuate widely in response to changing market forces. The Company maintains a commodity-price-risk management strategy that uses derivative instruments to minimize significant, unanticipated earning fluctuations caused by commodity-price volatility. The Company does not speculate using derivative instruments.

By using derivative financial instruments to reduce exposures to changes in commodity prices, the Company exposes itself to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes the Company, which creates credit risk for the Company. When the fair value of a derivative contract is negative, the Company owes the counterparty and, therefore, it does not incur credit risk. The Company minimizes the credit risk in derivative

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instruments by entering into transactions with high-quality counterparties whose credit rating is investment grade.

Market risk is the adverse effect on the value of a financial instrument that results from a change in commodity prices. The market risk associated with commodity-price contracts is managed by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken.

The Company periodically enters into natural gas and crude oil option contracts for a portion of its anticipated hydrocarbon sales, to reduce the price risk associated with fluctuations in market prices. The option contracts limit the unfavorable affect that price decreases will have on hydrocarbon sales. The maximum term over which the Company is hedging exposures to the variability of cash flows for commodity price risk is 24 months.

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(dollars in thousands, except share related items)

Effective January 1, 2001, the Company adopted SFAS No. 133 and SFAS No. 138, an amendment to SFAS 133. SFAS 133 and 138 require that derivatives be reported on the balance sheet at fair value and, if the derivative is not designated as a hedging instrument, changes in fair value must be recognized in earnings in the period of change. If the derivative is designated as a hedge and to the extent such hedge is determined to be effective, changes in fair value are either (a) offset by the change in fair value of the hedged asset or liability (if applicable) or (b) reported as a component of other comprehensive income (loss) in the period of change, and subsequently recognized in earnings when the offsetting hedged transaction occurs. During 2001 and 2002, the Company did not attempt to qualify for the hedge provisions under SFAS 133 and thus has not designated its derivative transactions during those periods as hedging instruments. Accordingly, the Company accounted for the changes in market value of these derivatives through current earnings.

As of December 31, 2002, the Company had hedged portions of its expected 2003 natural gas production as follows:

| Instrument | Volume (mmbtus) | Prices                  |
|------------|-----------------|-------------------------|
| Swaps      | 2,300,000       | \$3.95-\$4.08           |
| Collars    | 1,320,000       | floor \$3.50/cap \$6.00 |

The fair value of these derivative positions at that date was a \$1,352 liability.

**NOTE 7 EQUITY TRANSACTIONS**

At December 31, 2002, the Company had 85,000 shares of Series A preferred stock issued and outstanding. The preferred stock is convertible at the option of the holder at a rate of \$100 per share of common stock upon the occurrence of certain qualifying events. The preferred stock has voting rights as if converted. Each share has a liquidation preference of \$1,000. Dividends accrue at a rate of 8% per annum, become payable quarterly as declared, and are cumulative and payable in the event of liquidation of the Company. At December 31, 2002 and 2001, there were \$9,349 and \$3,510, respectively, of undeclared dividends in arrears.

During 2002, the Company issued four private placements of Series A preferred stock in the amounts of \$5,000, \$10,000, \$5,000, and \$10,000, which were consummated on April 22, 2002, June 17, 2002, September 3, 2002, and November 5, 2002, respectively. During 2001, the Company issued three private placements of Series A preferred stock, each in the amount of \$10,000, which closed on May 15, July 23, and November 19, 2001. As discussed in Note 1, Cheniere has a right to participate in offerings of Series A preferred stock by the Company. Cheniere elected not to participate in any of the Company's offerings during 2002 or 2001. Based upon the conversion features of the Company's Series A preferred stock, the interests of the Company's holders of Series A preferred stock would represent approximately 91%, and 80% on an as converted basis of the outstanding and issued Common Stock at December 31, 2002 and 2001, respectively.

As further discussed in Note 8, in July 2001, the Company acquired a 3D seismic data set from Cheniere. In connection with that transaction, the Company repurchased 6,740 shares of Common Stock for aggregate consideration of approximately \$418. These shares are included as treasury stock as of December 31, 2002.

In March 2002, the Company and Cheniere settled litigation which had been filed against them on a joint and several basis by a seismic company (the Claimant). Pursuant to this settlement, the Company made a payment to the Claimant and committed to make certain additional payments if production rights are obtained by the Company or Cheniere in the area covered by the data set licensed from the Claimant. In addition, the Company agreed to become responsible for certain contingent obligations of Cheniere associated with the Seitel data set. The maximum amount of the assumed liabilities associated with this litigation and the contingent liabilities associated with the Seitel dataset was approximately \$2,561 in the aggregate. As consideration for the Company's agreement to assume these contingent liabilities, Cheniere has transferred to Gryphon 51,400 shares of the Company's common stock which Cheniere held. Pursuant to this agreement, Cheniere has an option valid until March 16, 2003 to repurchase these shares from the Company at a cost equal to \$50 per share, subject to an escalation adjustment. At December 31, 2002, the maximum amount of the contingent obligations assumed is \$934.

Based upon the foregoing transactions, Cheniere holds an interest of approximately 9% in the Company, calculated on a fully diluted basis as of December 31, 2002.

#### **NOTE 8 STOCK-BASED COMPENSATION**

In 2000, the Company established the Gryphon Exploration Company 2000 Stock Option Plan (the Option Plan). In 2001, the Option Plan was amended and restated. The Option Plan, as amended, allows for the issuance of options to purchase up to 186,493 shares of Gryphon common stock at an exercise price of \$100 per share. The Company has reserved an equivalent number of shares of

**Table of Contents****GRYPHON EXPLORATION COMPANY****NOTES TO FINANCIAL STATEMENTS (Continued)**

(dollars in thousands, except share related items)

common stock for issuance upon the exercise of options which have been granted or which may be granted. The term of options granted under the Option Plan is generally ten years. Vesting occurs over a three-year period, one third on each anniversary of the grant date. The following table summarizes the Company's stock option activity and related information for the periods presented:

|  | Year ended   |           |
|--|--------------|-----------|
|  | December 31, |           |
|  | 2002         | 2001      |
| Outstanding at Beginning of Period                                 | 81,122       | 39,400    |
| Options Granted at an Exercise Price of \$100 per share            | 20,332       | 42,722    |
| Options Forfeited  | (350)        | (1,000)   |
| Outstanding at End of Period                                       | 101,104      | 81,122    |
| Exercisable at End of Period                                       | 40,604       | 13,483    |
| Weighted Average Exercise Price of Options Outstanding             | \$ 100       | \$ 100    |
| Weighted Average Exercise Price of Options Exercisable             | \$ 100       | \$ 100    |
| Weighted Average Fair Value of Options Granted During the Period   | \$           | \$        |
| Weighted Average Remaining Contractual Life of Options Outstanding | 8.44 years   | 9.3 years |
| Weighted Average Remaining Contractual Life of Options Exercisable | 8.11 years   | 8.8 years |

The fair value of options is calculated using the Black-Scholes option-pricing model. Assumptions used for 2002 and 2001 were: no dividend yield, no volatility, risk-free interest rate of 4.3% and 3.8%, respectively, and an expected average option life of 5 years. If the Company had adopted the recognition provisions of SFAS No. 123 for 2002 and 2001, the Company's financial statements would have not reflected a change in reported net income.

**NOTE 9 RELATED PARTY TRANSACTIONS**

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Under the terms of the Contribution and Subscription Agreement dated October 11, 2000 by and among the Company, Cheniere and the other investors listed therein, Gryphon provided office space to Cheniere at no cost from Inception through December 2000. Also, pursuant to that agreement, Cheniere provided accounting and cash management services to Gryphon without charge for six months following the closing date.

In April 2001, Gryphon purchased from Cheniere a 50% working interest in a Texas offshore lease for cash consideration of \$225, and simultaneously executed a joint operating agreement which provided that Gryphon would become the operator of the lease.

In June 2001, Gryphon completed a transaction with Cheniere for the purchase of a license for 3D seismic data (the Seitel data set) granted to Cheniere by Seitel Data Ltd. As a result of this transaction, Gryphon acquired the rights to approximately 3,900 square miles of seismic data in the Gulf of Mexico for a total purchase price of \$3,500.

In July 2001, Gryphon purchased the right arising under an agreement between JEBSCO and Cheniere whereby Cheniere was to receive a seismic data license (the JEBSCO data set) to approximately 3,000 square miles of 3D seismic data in the Gulf of Mexico. As part of this transaction, Gryphon also acquired 6,740 shares of Gryphon common stock from Cheniere. The aggregate purchase price of \$4,174 was allocated between seismic data and treasury stock based upon their relative fair values at date of the transaction.

As discussed in Note 7 above, in March 2002, the Company entered into a settlement agreement to resolve litigation against Cheniere and the Company. Pursuant to the settlement, the Company agreed to assume certain obligations of Cheniere. The maximum amount of the assumed liabilities pursuant to the settlement and associated agreements was approximately \$2,561 in the aggregate. As consideration for the Company's agreement to assume these contingent liabilities, Cheniere transferred to Gryphon 51,400 shares of the Company's common stock which Cheniere held. Pursuant to this agreement, Cheniere has an option valid for one year from the date of the agreement to repurchase these shares from the Company at a cost equal to \$50 per share, subject to escalation beginning four months after the date of the stock transfer. At December 31, 2002, Cheniere had not exercised any its repurchase rights under the option agreement.

During 2000, 2001, and 2002, the Company issued nine private placements of Series A preferred stock for aggregate consideration of \$85,000. Of this amount, Warburg contributed \$84,679 and the Company's management contributed \$321 (see Note 7).



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**GRYPHON EXPLORATION COMPANY**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

(dollars in thousands, except share related items)

**NOTE 10 COMMITMENTS AND CONTINGENCIES**

The Company has entered into an office lease agreement with a non-cancelable term, which runs through March 2003. Future minimum lease payments are \$66 for the year ended December 31, 2003. Total rental expense for office space for 2002 and 2001 was \$286 and \$285, respectively.

At Inception, Gryphon acquired a master license agreement covering the license of approximately 8,800 square miles of 3-D seismic data in the Gulf of Mexico. In connection with the license agreement, the Company has made a commitment to reprocess certain of the seismic data and to pay a fee for such reprocessing as the reprocessed data are delivered. At December 31, 2002, the Company had met its commitments related to future deliveries of reprocessed data.

In connection with the purchase from Cheniere of the JEBCO data set (see Note 9), the Company has an obligation to pay for the related seismic data once it has been delivered to the Company, and accepted by Cheniere.

**NOTE 11 OIL AND GAS OPERATIONS**

The Company uses the full cost method of accounting for its oil and natural gas properties. Unproved oil and gas properties include costs that are excluded from proved oil and gas properties and that are not subject to amortization. These amounts generally represent costs of investments in unproved properties, non-producing leases, seismic data sets, and major development projects. Gryphon excludes these costs until proved reserves are found or it is determined that the costs are impaired. The costs of unproved oil and natural gas properties are reviewed at least annually to determine if impairment has occurred. Any impairment is transferred to the proved oil and gas property pool. The Company evaluates significant properties, composed primarily of costs associated with offshore leases and seismic data sets, at least annually. Non-producing leases are evaluated based on the progress of the Company's exploration program to date.

The following table summarizes the costs of unproved properties for the periods during which the costs were incurred:

| <b>December 31,</b> |             |
|---------------------|-------------|
| <b>2002</b>         | <b>2001</b> |
|                     |             |

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| Period that costs were incurred     |                   |                   |
|-------------------------------------|-------------------|-------------------|
| Inception through December 31, 2000 | \$ 15,469         | \$ 15,469         |
| 2001                                | 12,598            | 12,598            |
| 2002                                | 8,618             |                   |
|                                     | <u>          </u> | <u>          </u> |
| <b>Totals</b>                       | <b>\$ 36,685</b>  | <b>\$ 28,067</b>  |
|                                     | <u>          </u> | <u>          </u> |

**NOTE 12 SUBSEQUENT EVENTS**

On February 10, 2003, the Company entered into a three-year, reserve based, revolving credit facility. The nominal amount of the facility is \$100,000 and the initial borrowing base is \$18,000. The borrowing base will be adjusted from time to time based upon changes in the Company's oil and gas reserves. The facility is secured by substantially all of the Company's assets, consisting primarily of its oil and gas properties. Proceeds borrowed from the facility can be used to fund the Company's operations, for acquisitions, and for general corporate purposes. The facility requires quarterly interest payments based upon up floating rate indexes and includes covenants typically associated with similar credit agreements. The credit facility matures February 10, 2006. As of March 14, 2003, the Company had drawn \$5,000 under the facility.

In January 2003, the Company entered into an amendment and extension to its office lease. Pursuant to this amendment, the Company expanded its office space by approximately 40% and extended the term by seven years from March 2003. The extended term includes an option which allows the Company to terminate the lease at the end of the fifth year of the extension period. The estimated aggregate obligation of the Company pursuant to the amendment is approximately \$2,990 assuming a seven year extension or approximately \$2,170 assuming the extension is terminated at the end of year five.

**NOTE 13 RECENT ACCOUNTING DEVELOPMENTS**

In July 2003, an issue was brought before the Financial Accounting Standards Board regarding whether or not contract-based oil and gas mineral rights held by lease or contract ( mineral rights ) should be recorded or disclosed as intangible assets. The issue presents a view that these mineral rights are intangible assets as defined in SFAS No. 141, Business Combinations, and, therefore, should be classified separately on the balance sheet as intangible assets. SFAS No. 141 and SFAS No. 142, Goodwill and Other Intangible Assets, became effective for transactions subsequent to June 30, 2001; with the disclosure requirements of SFAS No. 142 required as of January 1, 2002. SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for

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**GRYPHON EXPLORATION COMPANY**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

(dollars in thousands, except share related items)

using the purchase method and that intangible assets be disaggregated and reported separately from goodwill. SFAS No. 142 established new accounting guidelines for both finite lived intangible assets and indefinite lived intangible assets. Under the statement, intangible assets should be separately reported on the face of the balance sheet and accompanied by disclosure in the notes to financial statements. SFAS No. 142 does not apply to accounting utilized by the oil and gas industry as prescribed by SFAS No. 19, and is silent about whether or not its disclosure provisions apply to oil and gas companies. The Emerging Issues Task Force (EITF) has added the treatment of oil and gas mineral rights to an upcoming agenda, which may result in a change in how Gryphon classifies these assets.

Should such a change be required, the amounts related to business combinations and major asset purchases that would be classified as intangible undeveloped mineral interest was \$10,690 as of December 31, 2002. The amounts related to business combinations and major asset purchases that would be classified as intangible developed mineral interest was \$1,408 as of December 31, 2002. Intangible developed mineral interest amounts are presented net of accumulated depletion, depreciation and amortization (DD&A). Accumulated DD&A was estimated using historical depletion rates applied proportionately to the costs of the purchases conceptually classified as intangible developed mineral interest. The amounts noted above only include mineral rights acquired in major asset purchases, consisting primarily of amounts paid for federal and state oil & gas leases.

The numbers above are based on our understanding of the issue before the EITF: if all mineral rights associated with unevaluated property and producing reserves were deemed to be intangible assets:

mineral rights with proved reserves and mineral rights with no proved reserves would be classified as intangible assets and would not be included in oil and gas properties on our consolidated balance sheet;

results of operations and cash flows would not be materially affected because mineral rights would continue to be amortized in accordance with full cost accounting rules; and

disclosures required by SFAS Nos. 141 and 142 relative to intangibles would be included in the notes to our financial statements.

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(dollars in thousands)

**SUPPLEMENTAL OIL AND GAS DISCLOSURES (UNAUDITED)**

The following tables set forth information about the Company's oil and gas producing activities pursuant to the requirements of Statement of Financial Accounting Standards No. 69, Disclosures About Oil and Gas Producing Activities (SFAS 69).

Investments in oil and gas properties are set forth below:

|  | <b>December 31,</b> |
|--|---------------------|
|  | <b>2002</b>         |
| <b>Oil and Gas Properties:</b>                               |                     |
| Proved   | \$ 61,583           |
| Unproved   | 36,685              |
|  | <b>98,268</b>       |
| Less Accumulated Depreciation,<br>Depletion and Amortization | (7,261)             |
|  | <b>\$ 91,007</b>    |

As of December 31, 2002 and 2001, the Company's investment in oil and gas properties included \$36,685 and \$28,067, respectively in unevaluated properties, which have been excluded from amortization. Such costs will be evaluated in future periods based on management's assessment of exploration activities, expiration dates of licenses, permits and concessions, changes in economic conditions and other factors.

The Company began production of oil and gas in February 2001. The Company capitalized as oil and gas property costs approximately \$2,048 and \$2,023 of general and administrative expenses directly related to its exploration and development activities in 2002 and 2001, respectively.

The Company has made a substantial investment in acquiring, processing and reprocessing Gulf of Mexico seismic data, which cover various areas having an aggregate size of 18,000 square miles. The costs of these projects become subject to amortization on a ratable basis as prospects

are identified in each of the data set project areas.

**Costs Incurred**

Costs incurred in oil and gas property acquisition, exploration, and development activities are set forth in the table below:

|                            | Year ended       |                  |
|----------------------------|------------------|------------------|
|                            | December 31,     |                  |
|                            | 2002             | 2001             |
| Acquisition of Properties: |                  |                  |
| Proved Properties          | \$               | \$               |
| Unproved Properties        | 8,414            | 4,377            |
| Exploration Costs          | 19,788           | 22,254           |
| Development Costs          | 15,288           | 9,948            |
| <b>Total</b>               | <b>\$ 43,490</b> | <b>\$ 36,579</b> |

For the years ended December 31, 2002 and 2001 depreciation, depletion and amortization of the capitalized costs of oil and gas properties was \$1.70 and \$1.52 per mcf, respectively.

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(dollars in thousands)

**Reserve Quantities**

The following table shows estimates of proved reserves and proved developed reserves, net of royalty interest, of natural gas, crude oil, and condensate owned at year-end and changes in proved reserves during the last two years prepared by independent petroleum engineers in accordance with the rules and regulations of the Securities and Exchange Commission. Volumes for natural gas are in millions of cubic feet (mmcf) at the official temperature and pressure bases of the areas in which the gas reserves are located. Liquid hydrocarbons, consisting of oil and condensates, are expressed in standard 42 gallon barrels (bbls). These estimates represent the Company's interest in the reserves associated with its properties. All of the Company's oil and gas reserves are located within the United States and its territorial waters.

The Company's reserves increased in 2002 and 2001 primarily from exploration and development drilling activities, offset in part by production. The Company emphasizes that the volumes of reserves shown below are estimates which, by their nature, are subject to revision. The estimates are made using all available geological and reservoir data as well as production performance data. These estimates are reviewed and revised, either upward or downward, as warranted by additional data. Revisions are necessary due to changes in assumptions based on, among other things, reservoir performance, prices, economic conditions and governmental restrictions. Decreases in prices, for example, may cause a reduction in some proved reserves due to uneconomic conditions.

|   | Year Ended December 31, |               |                |               |
|---|-------------------------|---------------|----------------|---------------|
|   | 2002                    |               | 2001           |               |
|   | Oil<br>(Bbls)           | Gas<br>(Mmcf) | Oil<br>(Bbls)  | Gas<br>(Mmcf) |
| <b>Proved Reserves:</b>                     |                         |               |                |               |
| Beginning of Period                         | 210,151                 | 17,468        | 2,640          | 1,674         |
| Revisions of Previous Estimates             | (41,342)                | (3,904)       | (845)          | (1,268)       |
| Extensions, Discoveries and Other Additions | 243,319                 | 17,222        | 219,099        | 17,822        |
| Production                                  | (40,320)                | (3,278)       | (10,743)       | (760)         |
| <b>End of Period</b>                        | <b>371,808</b>          | <b>27,508</b> | <b>210,151</b> | <b>17,468</b> |
| <b>Proved Developed Reserves:</b>           |                         |               |                |               |
| Beginning of Period                         | 192,569                 | 13,022        | 2,640          | 1,674         |
| End of Period                               | 165,421                 | 16,332        | 192,569        | 13,022        |

There are numerous uncertainties inherent in estimating quantities of proved reserves and in projecting future rates of production and future amounts and timing of development expenditures, including many factors beyond the control of the Company. Reserve engineering is a subjective process of estimating underground accumulations of crude oil and natural gas that cannot be measured in an exact manner, and the accuracy of any reserve estimate is a function of the quality of available data and of engineering and geological interpretation and judgment. Estimates of proved undeveloped reserves are inherently less certain than estimates of proved developed reserves. The quantities of oil and gas that are ultimately recovered, production and operating costs, the amount and timing of future development expenditures, geologic success and future oil and gas sales prices may all differ from those assumed in these estimates. In addition, the Company's reserves may be subject to downward or upward revision based upon production history, purchases or sales of properties, results of future development, prevailing oil and gas prices and other factors.

#### **Standardized Measure of Discounted Future Net Cash Flows**

The following table sets forth estimates of future cash flows from proved reserves of gas, oil and condensate which were prepared by independent petroleum engineers. The standardized measure of discounted future cash flow amounts are based upon year-end prices of \$31.35 and \$20.43 per barrel of oil (WTI Cushing) and \$4.75 and \$2.64 per mcf of natural gas (NYMEX Henry Hub) at December 31, 2002 and 2001, respectively. Estimated future cash inflows are reduced by estimated future development and production costs based on year-end cost levels, assuming continuation of existing economic conditions, and by estimated future income tax expense. Income tax expense is calculated by applying the existing statutory tax rates, including any known future changes, to the pre-tax net cash flows giving effect to any permanent differences and reduced by the applicable tax basis. The effect of tax credits is considered in determining the income tax expense.

The present value of future net revenues does not purport to be an estimate of the fair market value of Gryphon's proved reserves. An estimate of fair value would also take into account, among other things, anticipated changes in future prices and costs, the

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(dollars in thousands)

expected recovery of reserves in excess of proved reserves and a discount factor more representative of the time value of money and the risks inherent in producing oil and gas. Significant changes in estimated reserve volumes or commodity prices could have a material effect on the Company's financial statements.

Under the full cost method of accounting, a non-cash charge to earnings related to the carrying value of the Company's oil and gas properties on a country-by-country basis may be required when prices are low. Whether the Company will be required to take such a charge depends on the prices for crude oil and natural gas at the end of any quarter, as well as the effect of both capital expenditures and changes to proved reserves during the quarter. If a non-cash charge were required, it would reduce earnings for the period and result in lower DD&A expense in future periods.

The standardized measure of discounted future net cash flows relating to proved oil and gas reserves is set forth in the following table:

|  | <b>December 31,</b> |                  |
|--|---------------------|------------------|
|  | <b>2002</b>         | <b>2001</b>      |
| Future Cash Inflows (Sales)                                | \$ 148,628          | \$ 49,949        |
| Less Future Costs:   |                     |                  |
| Production   | (8,923)             | (4,499)          |
| Development and Dismantlement                              | (7,288)             | (2,926)          |
| Future Net Cash Flows before Income Taxes                  | 132,417             | 42,524           |
| Less 10% Annual Discount for Estimated Timing of Cash Flow | (25,477)            | (9,956)          |
| Present Value of Future net Cash Flows before Income Taxes | 106,940             | 32,568           |
| Less Present Value of Future Income Taxes                  | (11,728)            | (3,790)          |
| Standardized Measure of Discounted Future net Cash Flows   | <b>\$ 95,212</b>    | <b>\$ 28,778</b> |

The following table summarizes the principal sources of change in the standardized measure of discounted future net cash flows:



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|   | Year ended   |           |
|---|--------------|-----------|
|   | December 31, |           |
|   | 2002         | 2001      |
| Standardized Measure Beginning of Period  | \$ 28,778    | \$ 9,139  |
| Increases (Decreases)   |              |           |
| Sales, net of Production Costs  | (8,465)      | (2,128)   |
| Increase due to passage of time (Accretion of Discount)   | 3,257        | 975       |
| Net Change in Sales Prices, net of Production Costs   | 24,104       | (11,258)  |
| Changes in Estimated Future Development Costs   | 122          |           |
| Revisions of Quantity Estimates   | (14,784)     | (3,047)   |
| Extensions, Discoveries and Other Additions, net of Future Production and Development Costs     | 69,357       | 34,232    |
| Development Costs Incurred during the Period that Reduced Previously Estimated Development Cost | 1,308        | 735       |
| Net Change in Income Taxes  | (7,938)      | 138       |
| Changes in Production Rates (timing) and Other  | (528)        | (8)       |
| Standardized Measure End of Period  | \$ 95,211    | \$ 28,778 |