PostRock Energy Corp
Form 10-Q
November 12, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2015

Commission file number: 001-34635

POSTROCK ENERGY CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	27-0981065

(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

210 Park Avenue, Oklahoma City, OK 73102

(Address of principal executive offices) (Zip Code)

(405) 600-7704

(Registrant's telephone number, including area code)

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 past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer		Accelerated filer
Non-accelerated filer	(Do not check if a smaller reporting company)	Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

At October 30, 2015, there were 6,550,796 outstanding shares of the registrant's common stock having an aggregate market value of $2.8 million based on a closing price of $.43 per share.

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POSTROCK ENERGY CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2015

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PART I — FINANCIAL INFORMATION

EXPLANATORY NOTE--RESTATEMENT OF FINANCIAL INFORMATION

On March 20, 2015, the Audit Committee of the Board of Directors (the "Audit Committee") of PostRock Energy Corporation (the “Company”), on the recommendation of management, and after consultation with the Company’s current and predecessor independent registered public accounting firms, BDO USA, LLP and UHY LLP, respectively, concluded that the Company’s audited consolidated financial statements and related consolidated financial information for each of the fiscal years ended December 31, 2010, 2011, 2012, and 2013, and the related reports of the Company’s independent registered public accounting firm thereon, and the unaudited condensed consolidated financial statements for the quarters ended March 31, 2014, June 30, 2014 and September 30, 2014, and for each of the quarters in the years ended December 31, 2011, 2012 and 2013, and for the quarter ended September 30, 2010 (collectively, the "Restated Periods") should no longer be relied upon because of an accounting error.

On March 31, 2015, the Company filed its Annual Report on Form 10-K for the year ended December 31, 2014 (the “Form 10-K”), which included (1) a restated balance sheet as of December 31, 2013, (2) restated consolidated statements of operations, consolidated statements of cash flows, and consolidated statements of stockholders’ equity (deficit) for the years ended December 31, 2012 and 2013, (3) restated quarterly financial information for the quarters ended March 31, 2014 and 2013, June 30, 2014 and 2013, and September 30, 2014 and 2013, and December 31, 2013, and (4) restated selected financial data for the years ended December 31, 2010, 2011, 2012, and 2013. For more information concerning these restatements, see Item 6, “Selected Financial Data,” Item 8, “Financial Statements and Supplementary Data,” and Item 9A, “Controls and Procedures,” in Part II of the Form 10-K.

This Quarterly Report on Form 10-Q for the quarter ended September 30, 2015, includes restated consolidated statements of operations and cash flows for the three and nine month periods ended September 30, 2014. We do not plan to amend previously filed reports in connection with the restatement. The financial information that has been previously filed or otherwise reported for the three and nine month periods ended September 30, 2014 is superseded by the information in this Quarterly Report on Form 10-Q. Unless otherwise stated, all financial and accounting information contained in this Quarterly Report on Form 10-Q is presented on a restated basis.

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Item 1. Financial Statements

POSTROCK ENERGY CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

(Unaudited)

	December 31, 2014	September 30, 2015
ASSETS		
Current assets		
Cash and cash equivalents	$ 46	$ 2,626
Accounts receivable—trade, net	9,080	3,913
Other receivables	515	1,560
Inventory	1,042	1,178
Other	1,031	771
Derivative financial instruments	11,151	8,620
Total	22,865	18,668
Oil and natural gas properties, full cost method of accounting, net	153,240	64,151
Other property and equipment, net	11,829	9,487
Derivative financial instruments	6,162	432
Other, net	1,579	1,167
Total assets	$ 195,675	$ 93,905
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current liabilities		
Accounts payable	$ 9,278	$ 2,518
Revenue payable	4,051	3,065
Accrued expenses and other	3,283	3,616
Current maturities of long-term debt	—	3,580
Total	16,612	12,779
Long-term debt, less current maturities	83,000	74,620
	63,954	72,467

Mandatorily redeemable Series A preferred stock, $0.01 par value; 5,075 shares issued and outstanding		
Asset retirement obligations	13,884	14,234
Other	1	—
Total liabilities	177,451	174,100
Commitments and contingencies (Note 11)		
Stockholders’ equity (deficit)		
Preferred stock, $0.01 par value; 5,000,000 authorized shares; 23,098 and 76,524 shares of Series B Voting Preferred Stock issued and outstanding, respectively	—	1
Common stock, $0.01 par value; 100,000,000 authorized shares; issued—6,523,811 and 7,083,857; outstanding—6,336,728 and 6,559,936 respectively	65	71
Additional paid-in capital	481,050	485,258
Treasury stock, at cost	(2,432)	(2,856)
Accumulated deficit	(460,459)	(562,669)
Total stockholders’ equity (deficit)	18,224	(80,195)
Total liabilities and stockholders’ equity (deficit)	$ 195,675	$ 93,905

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

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POSTROCK ENERGY CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended September 30, 2014 (Restated)	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2014 (Restated)	Nine Months Ended September 30, 2015
	(in thousands, except per share data)			
Revenues				
Natural gas sales	$ 12,850	$ 8,058	$ 43,469	$ 24,548
Crude oil sales	7,818	2,176	19,117	8,482
Gathering	631	429	2,112	1,302
Total	21,299	10,663	64,698	34,332
Costs and expenses				
Production	10,809	8,676	31,645	27,414
General and administrative	3,195	2,443	10,605	8,833
Depreciation, depletion and amortization	7,257	6,092	21,516	20,701
Impairment of oil and natural gas properties	—	34,867	—	74,261
Gain on disposal of assets	(42)	(90)	(120)	(289)
Acquisition costs	—	—	47	—
Total	21,219	51,988	63,693	130,920
Operating income (loss)	80	(41,325)	1,005	(96,588)
Other income (expense)				
Gain (loss) from derivative financial instruments	6,445	3,442	(1,489)	7,203
Gain on investment	2,919	—	4,625	289
Other income (expense), net	(10)	(9)	(5)	326
Interest expense, net	(5,058)	(4,625)	(14,827)	(13,440)
Total	4,296	(1,192)	(11,696)	(5,622)
Net Income (loss) before income taxes	4,376	(42,517)	(10,691)	(102,210)
Income taxes	—	—	—	—
Net income (loss) attributable to common stockholders	$ 4,376	$ (42,517)	$ (10,691)	$ (102,210)
Net income (loss) per common share				
Basic income (loss) per share	$ 1.36	$ (6.20)	$ (3.38)	$ (15.23)
Diluted income (loss) per share	$ 1.35	$ (6.20)	$ (3.38)	$ (15.23)
Weighted average common shares outstanding				
Basic	3,218	6,858	3,166	6,711
Diluted	3,241	6,858	3,166	6,711

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

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POSTROCK ENERGY CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended September 30, 2014 (Restated)	Nine Months Ended September 30, 2015
	(in thousands)	
Cash flows from operating activities		
Net loss	$ (10,691)	$ (102,210)
Adjustments to reconcile net loss to net cash flows from operating activities		
Depreciation, depletion and amortization	21,516	20,701
Impairment of oil and natural gas properties	—	74,261
Share-based and other compensation	2,487	1,563
Amortization of deferred loan costs	392	430
(Gain) loss on derivative financial instruments	1,489	(7,203)
Settlements received (paid) on derivative financial instruments	(4,610)	13,983
Gain on disposal of assets	(120)	(289)
Gain on investment	(4,625)	(289)
Other non-cash changes to items affecting net loss	12,080	10,823
Changes in operating assets and liabilities		
Accounts receivable	(229)	5,167
Accounts payable	(6,457)	(1,831)
Other	2,925	(391)
Net cash flows from operating activities	14,157	14,715
Cash flows used in investing activities		
Restricted cash	(1)	—
Proceeds from sale of investment	19,213	289
Expenditures for equipment, development and leasehold	(22,002)	(8,138)
Proceeds from sale of assets	607	380
Net cash flows used in investing activities	(2,183)	(7,469)
Cash flows from used in financing activities		
Proceeds from debt	47,000	18,000
Repayments of debt	(59,000)	(22,800)
Debt and equity financing costs	(11)	—
Proceeds from issuance of common stock	—	134
Net cash flows used in financing activities	(12,011)	(4,666)
Net increase (decrease) in cash and cash equivalents	(37)	2,580

Cash and cash equivalents beginning of period	37	46
Cash and cash equivalents end of period	$ —	$ 2,626

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

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POSTROCK ENERGY CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (DEFICIT)

(Amounts subsequent to December 31, 2014 are unaudited)

	Preferred Shares	Preferred Stock Par Value	Common Shares Issued	Common Stock Par Value	Additional Paid-in Capital	Shares of Treasury Stock	Treasury Stock	Accumulated Deficit	Total Shareholder Equity (Deficit)
	(in thousands, except share data)								
Balance, December 31, 2014	23,098	$ —	6,523,811	$ 65	$ 481,050	187,083	$ (2,432)	(460,459)	$ 18,224
Stock-based compensation	—	—	—	—	410	—	—	—	410
Restricted stock grants, net of forfeitures	—	—	94,945	2	9	2,369	(9)	—	2
Funding of 401K and deferred compensation plans	—	—	436,685	4	1,345	334,469	(415)	—	934
Issuance of Series B preferred stock	53,426	1	—	—	—	—	—	—	1
Issuance of warrants	—	—	—	—	2,310	—	—	—	2,310
Issuance of common stock, net	—	—	28,416	—	134	—	—	—	134
Net loss	—	—	—	—	—	—	—	(102,210)	(102,210)
Balance, September 30, 2015	76,524	$ 1	7,083,857	$ 71	$ 485,258	523,921	$ (2,856)	(562,669)	$ (80,195)

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

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POSTROCK ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 — Basis of Presentation

PostRock Energy Corporation is an independent oil and gas company engaged in the acquisition, exploration, development, production and gathering of crude oil and natural gas. Its primary production activity is focused in the Cherokee Basin, a 15-county region in southeastern Kansas and northeastern Oklahoma, and in Central Oklahoma. It also has minor oil and natural gas producing properties in the Appalachian Basin. Unless the context requires otherwise, references to “PostRock,” the “Company,” “we,” “us” and “our” refer to PostRock Energy Corporation and its consolidated subsidiaries.

The unaudited interim condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”), and reflect all adjustments that are, in the opinion of management, necessary for a fair statement of the results for the interim periods on a basis consistent with the annual audited consolidated financial statements. All such adjustments are of a normal recurring nature. Certain information, accounting policies and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the summary of significant accounting policies and notes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014 (the “2014 10-K”).

The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The operating results for the interim periods are not necessarily indicative of the results to be expected for the full year.

Certain reclassifications have been made to the prior periods’ financial statements to conform to the current period’s presentation. These reclassifications had no effect on the financial position, results of operations or cash flows of the Company.

Going Concern

The accompanying condensed consolidated financial statements have been prepared assuming that PostRock will continue as a going concern, which contemplates the realization of assets and the liquidation of liabilities in the normal course of business. The substantial drop in oil and natural gas prices since June 30, 2014 has significantly affected our revenue, profitability and cash flow and has led to an impairment of our oil and natural gas properties. Additionally, a decrease in the borrowing base under our senior secured revolving credit facility to $76 million led to a $10.4 million borrowing base deficiency at June 30, 2015, which is required to be repaid in installments through December 2015. Our next borrowing base redetermination will be effective in November 2015, at which time the Company expects further significant reductions. A significant borrowing base reduction could lead to an unmanageable deficiency and ultimately a default under the credit agreement. Upon an event of default under the credit agreement, the full amount of the debt would become callable. The Company is currently in discussions with its lenders regarding alternatives if these events occur, but can give no assurances that an agreement can reached on terms acceptable to the Company, or at all. In February 2015, the Company engaged Evercore Group L.L.C. to assist the Board in evaluating our strategic alternatives which include, among other things, merging or selling the Company, selling operating assets, obtaining additional capital from other sources and/or renegotiating the terms of our existing credit agreement sufficient to meet both our operating and financial obligations. While this evaluation is still under way, there can be no assurance that we will be successful in any of these efforts or that we will have sufficient funds to cover our operational and financial obligations over the next twelve months, which raises substantial doubt as to our ability to continue as a going concern. The condensed consolidated financial statements do not include any adjustments that might be necessary if the Company is unable to continue as a going concern.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

Note 2 — Other Balance Sheet Items

Components of the condensed consolidated balance sheet items are described below:

	December 31, 2014	September 30, 2015
	(in thousands)	
Other current assets		
Prepaid fees and deposits	$ 975	$ 741
Other	56	30
Total	$ 1,031	$ 771
Other noncurrent assets, net		
Deferred financing costs , net	$ 1,126	$ 726
Noncurrent deposits and other	453	441
Total	$ 1,579	$ 1,167
Accrued expenses and other		
Interest	$ 26	$ 191
Employee-related costs and benefits	1,870	905
Non-income related taxes	40	1,505
Fees for services	316	286
Asset retirement obligations	134	134
Other	897	595
Total	$ 3,283	$ 3,616
Other noncurrent liabilities		
Other	$ 1	$ —
Total	$ 1	$ —

Note 3 — Derivative Financial Instruments

The Company is exposed to commodity price risk and management believes it prudent to periodically reduce exposure to cash-flow variability resulting from this volatility. Accordingly, the Company enters into certain derivative financial instruments in order to manage exposure to commodity price risk inherent in its oil and natural gas production. Derivative financial instruments are also used to manage commodity price risk inherent in customer pricing requirements and to fix margins on the future sale of oil and natural gas. Specifically, the Company may utilize futures, swaps and options.

Derivative instruments expose the Company to counterparty credit risk. The Company's commodity derivative instruments are currently with two counterparties. The Company generally executes commodity derivative instruments under master agreements which allow it, in the event of default, to elect early termination of all contracts with the defaulting counterparty. If the Company chooses to elect early termination, all asset and liability positions with the defaulting counterparty would be net cash settled at the time of election.

The Company monitors the creditworthiness of its counterparties; however, it is not able to predict sudden changes in counterparties' creditworthiness. In addition, even if such changes are not sudden, it may be limited in its ability to mitigate an increase in counterparty credit risk. Possible actions include transferring its position to another counterparty or requesting a voluntary termination of the derivative contracts resulting in a cash settlement. Should one of these counterparties not perform, the Company may not realize the benefit of some of its derivative instruments under lower commodity prices as well as incur a loss.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

The Company does not designate its derivative financial instruments as hedging instruments for financial accounting purposes and, as a result, it recognizes the change in the respective instruments' fair value currently in earnings. The table below outlines the classification of derivative financial instruments on the condensed consolidated balance sheet and their financial impact on the condensed consolidated statements of operations at and for the periods indicated:

Derivative Financial Instruments	Balance Sheet location	December 31, 2014	September 30, 2015
		(in thousands)	
Commodity contracts	Current derivative financial instrument asset	$ 11,151	$ 8,620
Commodity contracts	Long-term derivative financial instrument asset	6,162	432
		$ 17,313	$ 9,052

Gains and losses associated with derivative financial instruments related to oil and natural gas production were as follows for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2015	2014	2015
	(in thousands)			

Settlements received (paid)	$ (178)	$ 4,820	$ (4,610)	$ 15,465
Change in fair value	6,623	(1,378)	3,121	(8,262)
Total gain (loss) from derivative financial instruments	$ 6,445	$ 3,442	$ (1,489)	$ 7,203

The Company entered into an International Swap Dealers Association Master Agreement (ISDA) with each of its two counterparties for which it holds derivative contracts. The ISDA is a standard contract that governs all derivative contracts entered into between the Company and the respective counterparty. The ISDA allows for offsetting of amounts payable or receivable between the Company and the counterparty, at the election of both parties, for transactions that occur on the same date and in the same currency. The Company has multiple oil swap contracts that could be offset under these provisions, but has not offset the fair values of its derivative assets due to the absence of any derivative liabilities on its condensed consolidated balance sheets. The ISDA also includes a master netting arrangement in the event of early termination or default.

The following table summarizes the estimated volumes, fixed prices and fair values attributable to all of the Company's oil and gas derivative contracts at September 30, 2015.

	Remainder of 2015	Year Ending December 31, 2016	Total
	($ in thousands, except per unit data)		
Natural Gas Swaps			

Contract volumes (MMBtu)	2,245,890	3,222,072	5,467,962
Weighted-average fixed price per MMBtu	$ 4.01	$ 3.97	$ 3.98
Fair value, net	$ 3,171	$ 3,801	$ 6,972
Crude Oil Swaps			
Contract volumes (Bbl)	17,892	29,392	47,284
Weighted-average fixed price per Bbl	$ 92.73	$ 90.96	$ 91.63
Fair value, net	$ 839	$ 1,241	$ 2,080
Total fair value, net	$ 4,010	$ 5,042	$ 9,052

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

Note 4 — Fair Value Measurements

Cash and Cash Equivalents, Accounts Receivable and Accounts Payable — The carrying amounts approximate fair value due to the short-term nature or maturity of the instruments.

Commodity Derivative Instruments — The Company's oil and natural gas derivative instruments may consist of variable to fixed price swaps, collars and basis swaps. When possible, the Company estimates the fair values of these instruments based on published forward commodity price curves as of the date of the estimate. The discount rate used in the discounted cash flow projections is based on published LIBOR rates adjusted for counterparty credit risk. Counterparty credit risk is incorporated into derivative assets while the Company's own credit risk is incorporated into derivative liabilities. Both are based on the current published credit default swap rates.

Investment — The Company had an investment in Constellation Energy Partners LLC, now named Sanchez Production Partners LLC ("SPP"), which consisted of 224,850 Class B units at December 31, 2014 (see Note 5 — Investment). Fair value for the Class B units, which are publicly traded, is based on market price and classified as a Level 1 measurement under the fair value hierarchy. At December 31, 2014, the fair value used for the Class B units was $1.40 per unit. During the first quarter of 2015, the Company sold the remaining Class B units in SPP and therefore the Company sold all of its assets classified as Level 1 in the fair value hierarchy.

The Company classifies assets and liabilities within the fair value hierarchy based on the lowest level of input that is significant to the fair value measurement of each individual asset and liability taken as a whole. Measurement information for assets and liabilities that are measured at fair value on a recurring basis was as follows:

	Level 1	Level 2	Level 3	Total Net Fair Value
	(in thousands)			
At December 31, 2014				
Investment, gross	$ 315	$ —	$ —	$ 315
Derivative financial instruments—assets	—	17,313	—	17,313
Total	$ 315	$ 17,313	$ —	$ 17,628
At September 30, 2015				
Derivative financial instruments—assets	$ —	$ 9,052	$ —	$ 9,052
Total	$ —	$ 9,052	$ —	$ 9,052

There were no movements between Levels 1 and 2 during the three and nine months ended September 30, 2015. The Company has not owned any Level 3 assets or liabilities since 2012.

Additional Fair Value Disclosures — The Company had 5,075 outstanding shares of Series A Cumulative Redeemable Preferred Stock (“Series A Preferred Stock”) (see Note 8 — Redeemable Preferred Stock and Warrants) at September 30, 2015. The obligation to redeem the preferred shares is reflected as debt (“mandatorily redeemable preferred stock”) in the condensed consolidated balance sheet (see Note 8 — Redeemable Preferred Stock and Warrants). The fair value and the carrying value of these securities at December 31, 2014 were $79.8 million and $64.0 million, respectively. The fair value and carrying value of these securities at September 30, 2015 is $87.2 million and $72.5 million, respectively. The fair value was determined by discounting the cash flows over the remaining life of the securities utilizing a LIBOR interest rate and a risk premium of approximately 10% at December 31, 2014 and 12.4% at September 30, 2015, which was based on companies with similar leverage ratios to PostRock. The Company has classified the valuation of these securities under Level 2 of the fair value hierarchy.

The Company’s debt consists entirely of floating-rate facilities. The carrying amount of floating-rate debt approximates fair value because the interest rates paid on such debt are generally set for periods of six months or shorter.

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POSTROCK ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

Note 5 — Investment

The Company elected the fair value option to account for its interest in SPP at inception. The fair value option was chosen as the Company determined that the market price of SPP's publicly traded interests provided a more accurate fair value measure of the Company's investment in SPP. The Company has not elected the fair value option for any of its other assets or liabilities. During the first quarter of 2015, the Company sold the remaining units in SPP and recorded a realized gain of $313,000 as shown in the table below.

The following table presents the mark-to-market and realized gains on the Company's investment (recorded as a component of other income in the condensed consolidated statements of operations):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2015	2014	2015
	(in thousands)			
Mark-to-market gains on investment	$ 2,252	$ —	$ 3,958	$ (24)
Realized gain	667	—	667	313

The following table presents the Company's investment in SPP at gross fair value, and the valuation allowance on SPP investment, which includes certain proceeds received from the settlement agreement as described below (presented net in the consolidated balance sheets):

	December 31, 2014	September 30, 2015

	(in thousands)		
Investment, at gross fair value	$ 315	$	—
Valuation allowance on investment	(315)		—

Note 6 — Impairments of Oil and Natural Gas Properties

Our oil and natural gas properties are subject to quarterly full cost ceiling tests. Under the ceiling test, capitalized costs, less accumulated depreciation, depletion and amortization and related deferred income taxes, may not exceed an amount equal to the sum of the present value of estimated future net revenues less estimated future expenditures to be incurred in developing and producing the proved reserves, less any related income tax effects. Estimated future net revenues for the quarterly ceiling limit are calculated using the average of commodity prices on the first day of the month over the trailing 12-month period. In the current quarter, net capitalized costs of oil and natural gas properties exceeded the ceiling, resulting in an impairment to the carrying value of our oil and natural gas properties of $34.9 million. In the nine months ended September 30, 2015, the net capitalized costs of oil and natural gas properties exceeded the ceiling, resulting in an impairment to the carrying value of our oil and natural gas properties of $74.3 million.

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POSTROCK ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

Note 7 — Asset Retirement Obligations

The following table reflects the changes to asset retirement obligations for the periods indicated:

	Nine Months Ended September 30,	
	2014	2015
	(in thousands)	
Asset retirement obligations at beginning of period	$ 13,228	$ 14,018
Liabilities incurred	37	—
Liabilities settled	(118)	(318)
Accretion	518	668
Asset retirement obligations at end of period	13,665	14,368
Current portion of asset retirement obligations	134	134
Noncurrent portion of asset retirement obligations	$ 13,531	$ 14,234

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POSTROCK ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

Note 8 — Long-Term Debt

The Company has a $200 million senior secured revolving credit facility (the “Borrowing Base Facility”) with the following outstanding balances:

	December 31, 2014	September 30, 2015
	(in thousands)	
Borrowing Base Facility	$ 83,000	$ 78,200
Less current maturities	—	(3,580)
Total long-term debt	$ 83,000	$ 74,620

On June 24, 2015, the Company entered into an amendment to its senior secured revolving credit facility, which among other things, reduced the borrowing base to $76 million as a result of the May 2015 redetermination and established a six-month schedule for the repayment or reduction of the resulting $10.4 million borrowing base deficiency by December 22, 2015. The next borrowing base redetermination will be effective in November 2015, at which time the Company expects further significant reductions. PostRock has remained in compliance with the six-month repayment schedule by reducing the borrowing base deficiency to $3.6 million by September 30, 2015 using cash on hand, cash flow from operations, proceeds from the sale of assets and/or settlements of hedges. Until the borrowing base deficiency is paid in full, the Company will not be able to reborrow any amounts repaid under the credit facility.

The Company was in compliance with all of its financial covenants under the credit facility at September 30, 2015 and November 11, 2015. Although the Company is in compliance at this time, it is probable that the Company will have covenant violations within the next twelve months. These violations could lead to a default under the credit agreement. Upon an event of default under the credit agreement, the full amount of the debt would become callable.

Note 9 — Redeemable Preferred Stock and Warrants

Prior to June 30, 2016, the Company may accrue dividends rather than pay them in cash for all outstanding Series A Preferred Stock. Whenever dividends are accrued on a quarterly dividend payment date, the liquidation preference of the Series A Preferred Stock is increased by the amount of the accrued dividends and additional warrants to purchase shares of PostRock common stock are issued. The Company records the increase in liquidation preference and the issuance of additional warrants by allocating their relative fair values to the amount of accrued dividends. The allocation results in an increase to the Company's mandatorily redeemable preferred stock related to the Series A Preferred Stock and an increase to additional paid in capital related to the additional warrants issued. The increase to additional paid in capital related to additional warrants issued for dividends paid in kind was $2.3 million during the nine months ended September 30, 2015. The following table summarizes changes in the Series A Preferred Stock and associated warrants:

	Carrying Value of Series A Preferred Stock	Number of Outstanding Series A Preferred Shares	Liquidation Value of Series A Preferred Stock	Number of Outstanding Warrants	Weighted Average Exercise Price of Warrants
	(in thousands except share, warrant and per unit data)				
December 31, 2014	$ 63,954	5,075	$ 79,760	3,301,249	$ 13.00
Accrued dividends	5,086	—	7,394	5,434,555	1.33
Accretion	3,427	—	—	—	—
September 30, 2015	$ 72,467	5,075	$ 87,154	8,735,804	$ 5.74

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POSTROCK ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

Note 10 — Equity and Earnings per Share

Share-Based Payments — The Company recorded share based compensation expense of $264,000 and $81,000 for the three months ended September 30, 2014 and 2015, respectively, and $609,000 and $410,000 for the nine months ended September 30, 2014 and 2015, respectively. Total share-based compensation to be recognized on unvested stock awards and options at September 30, 2015, is $559,000 over a weighted average period of 1.3 years. The following table summarizes option and restricted awards granted during 2015 and their associated valuation assumptions:

	Number of awards granted	Weighted fair value per option or share	Weighted exercise price	Weighted risk free rate	Weighted volatility
Options					
First quarter 2015 employee awards	—	$ —	$ —	— %	— %
Second quarter 2015 employee awards (3)	312,542	$ 1.21	$ 1.84	0.2 %	95.4 %
Third quarter 2015 employee awards (1)	—	$ —	$ —	— %	— %
Restricted Stock Awards					
First quarter 2015 employee awards	—	$ —	n/a	n/a	n/a
First quarter 2015 director awards (1)	3,750	$ 3.04	n/a	n/a	n/a
Second quarter 2015 employee awards (3)	87,571	$ 1.84	n/a	n/a	n/a
Second quarter 2015 director awards (1)(2)	28,674	$ 3.03	n/a	n/a	n/a
Third quarter 2015 director awards (1)	18,819	$ 2.73	n/a	n/a	n/a

(1) Awards vest immediately.
(2) Awards vest in one year – 14,000 shares

(3) Awards vest ratably over 3 years

Income/(Loss) per Share — A reconciliation of the denominator (number of shares) used in the basic and diluted per share calculations for the periods indicated is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2015	2014	2015
Denominator for basic earnings per share	3,217,881	6,857,655	3,165,761	6,710,590
Effect of potentially dilutive securities				
Stock options	—	—	—	—
Warrants	23,023	—	—	—
Denominator for diluted earnings per share	3,240,904	6,857,655	3,165,761	6,710,590
Securities excluded from earnings per share calculation due to antidilutive effect				
Stock options	263,706	406,294	263,706	391,226
Warrants	2,030,631	5,094,721	2,467,917	4,264,537

Common Stock Issuance — The Company had an effective universal shelf registration statement on Form S-3 until March of 2015. Pursuant to the registration statement, we implemented an at-the-market program under which shares of our common stock could be sold. In March 2015, our Board of Directors suspended the program. There were sales of 28,416 shares of common stock for net proceeds of $134,000 in the first two months of the year.

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POSTROCK ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

Note 11 — Commitments and Contingencies

Litigation — The Company is subject, from time to time, to certain legal proceedings and claims in the ordinary course of conducting its business. It records a liability related to its legal proceedings and claims when it has determined that it is probable that it will be obligated to pay and the related amount can be reasonably estimated. The Company currently believes that there are no pending legal proceedings in which it is currently involved which have a reasonable possibility of materially affecting its financial position, results of operations or cash flows in an adverse manner.

Contractual Commitments — The Company has numerous contractual commitments in the ordinary course of business including debt service requirements, operating leases and purchase obligations. During the three and nine months ended September 30, 2015, we have not entered into any significant contractual commitments that would increase the amounts included in our outstanding contractual commitments table at December 31, 2014.

Note 12 — Profit sharing and deferred compensation plans

401K plan — Substantially all of the Company's employees are eligible to participate in a profit sharing plan under Section 401(k) of the Internal Revenue Code (the "401K plan"). Under the plan, employer matching contributions may be made in cash or Company common stock. Prior to 2013, employer matching contributions to the 401K plan were made in cash. From 2013 until June 30, 2015, employer matching contributions to the 401K plan were made in Company common stock. In general, the Company issued common stock to fund its matching contributions although, from time to time, purchases of common stock on the open market by the 401K plan trust may occur if funds are available as a result of forfeitures. During the six months ended June 30, 2015, 87,091 shares of common stock were contributed to the 401K plan, of which 86,992 shares were issued by the Company. The Company expects to fund its third quarter matching contributions during the fourth quarter of 2015 in cash.

The following table presents the expense incurred by the Company related to the 401K plan which is reflected in the condensed consolidated statements of operations as a component of general and administrative expense:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2015	2014	2015
	(in thousands)			
401(k) profit sharing plan cost	$ 147	$ 117	$ 451	$ 410

Deferred compensation plan — Effective January 1, 2013, the Company established a deferred compensation plan that permits members of its board and certain employees to defer part or all of their eligible compensation. The Company issues common stock into a rabbi trust created to hold the assets associated with the plan. A participant's deferred compensation is credited with earnings, gains and losses based on the Company's common stock, the only investment option currently available under the plan. The Company may also make discretionary employer credits in an amount it determines each plan year. Distributions to participants will be made in shares of the Company's common stock. Company shares held in the rabbi trust are recorded as treasury stock in the condensed consolidated balance sheets. Changes in the fair value of the deferred compensation obligation, currently recorded as a component of paid-in capital, are not recognized.

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POSTROCK ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

The following table presents the number of shares and the related grant date fair values of common stock contributed by the Company to the deferred compensation plan for the three and nine months ended September 30, 2014 and 2015. The fair value of common stock is based on the market price of the stock on the preceding day that the stock is transferred and thus deemed to be a Level 1 measurement under the fair value hierarchy.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2015	2014	2015
	(in thousands, except per share amounts)			
Shares of common stock contributed	2,097	19,265	151,334	351,872
Fair value of common stock contributed	$ 31	$ 52	$ 1,955	$ 822

Note 13 — Restatement of Previously Issued Consolidated Financial Statements

Prior to the issuance of the Company’s 2014 consolidated financial statements, the Company concluded that its previously issued 2010, 2011, 2012 and 2013 consolidated financial statements should be restated because of a misinterpretation of the guidance around accounting for its Series A Preferred Stock issued in September 2010.

Background of Restatement – On September 21, 2010 and from time to time thereafter, the Company issued to White Deer Energy L.P. and its affiliates (“White Deer”) Series A Preferred Stock, Series B Preferred Stock and warrants to purchase shares of the Company’s common stock in exchange for cash. The Series A Preferred Stock was recorded outside of permanent equity and liabilities, in the Company’s consolidated balance sheet because the settlement provisions of the warrants allowed White Deer to “net exercise” the warrants by permitting White Deer to pay the exercise price of the warrant by delivering the Series A Preferred Stock with a liquidation preference equal to the exercise price that would otherwise be due from White Deer in cash. Although the terms of the Series A Preferred Stock has a mandatory redemption date attributed to it, the Company believed this provision associated with the warrants excluded the Series A Preferred Stock from the definition of mandatorily redeemable preferred stock under FASB ASC 480, “Distinguishing Liabilities from Equity.” The Company now believes that under U.S. generally accepted accounting principles, because the warrants are detachable, and thus are separate from the Series A Preferred Stock, the features of the warrants cannot be considered when evaluating the classification of the Series A Preferred Stock, and the Company therefore believes that the Series A Preferred Stock should have been classified as a liability for all periods from its issuance date.

Impact of the Restatement - The effect of the restatement on the Company’s consolidated balance sheets for each quarter and annual period end, beginning with September 30, 2010, consists of reclassifications of the Series A Preferred Stock from temporary equity to a liability. Additionally, dividends and accretion, originally taken to additional paid-in capital, have been reclassified to interest expense on the statement of operations. While these non-cash reclassifications have the effect of reducing net income (or increasing the net loss) in each period, they have no material impact on total stockholders’ equity, net income (loss) attributable to common stockholders, net income (loss) per common share or cash flows.

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POSTROCK ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

Details of the restatement for the three months ended September 30, 2014 are as follows:

	For the three months ended September 30, 2014		
	As Reported	Adjustment	Restated
	(in thousands, except per share data)		
Operating income	$ 80	$ —	$ 80
Other income (expense)			
Loss from derivative financial instruments	6,445	—	6,445
Gain on investment	2,919	—	2,919
Other expense, net	(10)	—	(10)
Interest expense, net	(3,437)	(1,621)	(5,058)
Total	5,917	(1,621)	4,296
Income before income taxes	5,997	(1,621)	4,376
Income taxes	—	—	—
Net Income	5,997	(1,621)	4,376
Preferred stock dividends	(1,116)	1,116	—
Accretion of redeemable preferred stock	(505)	505	—
Net income attributable to common stockholders	$ 4,376	$ —	$ 4,376
Net income per common share			
Basic	$ 1.36	$ —	$ 1.36
Diluted	$ 1.35	$ —	$ 1.35
Weighted average common shares outstanding			
Basic	3,218	—	3,218
Diluted	3,241	—	3,241

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POSTROCK ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

Details of the restatement for the nine months ended September 30, 2014 are as follows:

	For the nine months ended September 30, 2014		
	As Reported	Adjustment	Restated
	(in thousands, except per share data)		
Operating income	$ 1,005	$ —	$ 1,005
Other income (expense)			
Loss from derivative financial instruments	(1,489)	—	(1,489)
Gain on investment	4625	—	4,625
Other expense, net	(5)	—	(5)
Interest expense, net	(10,450)	(4,377)	(14,827)
Total	(7,319)	(4,377)	(11,696)
Loss before income taxes	(6,314)	(4,377)	(10,691)
Income taxes	—	—	—
Net loss	(6,314)	(4,377)	(10,691)
Preferred stock dividends	(3,066)	3,066	—
Accretion of redeemable preferred stock	(1,311)	1,311	—
Net Loss attributable to common stockholders	$ (10,691)	$ —	$ (10,691)
Net loss per common share			
Basic	$ (3.38)	$ —	$ (3.38)
Diluted	$ (3.38)	$ —	$ (3.38)
Weighted average common shares outstanding			
Basic	3,166	—	3,166
Diluted	3,166	—	3,166

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POSTROCK ENERGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

Details of the restatement for the nine months ended September 30, 2014 are as follows:

	For the nine months ended September 30, 2014		
	As Reported	Adjustment	Restated
	(in thousands, except per share data)		
Cash flows from operating activities			
Net loss	$ (6,314)	$ (4,377)	$ (10,691)
Adjustments to reconcile net loss to net cash flows from operating activities			
Depreciation, depletion and amortization	21,516		21,516
Share-based and other compensation	2,487		2,487
Amortization of deferred loan costs	392	—	392
Loss from derivative financial instruments	1,489	—	1,489
Settlement of derivative financial instruments	(4,610)	—	(4,610)
Gain on disposal of assets	(120)	—	(120)
Gain on investment	(4,625)	—	(4,625)
Other non-cash changes to items affecting net loss	7,703	4,377	12,080
Changes in operating assets and liabilities			
Accounts receivable	(229)	—	(229)
Accounts payable	(6,457)	—	(6,457)
Other	2,925	—	2,925
Net cash flows from operating activities	14,157	—	14,157
Cash flows used in investing activities			
Restricted cash	(1)	—	(1)
Proceeds from sale of investment	19,213	—	19,213
Expenditures for equipment, development and leasehold	(22,002)	—	(22,002)
Proceeds from sale of assets	607	—	607
Net cash flows used in investing activities	(2,183)	—	(2,183)
Cash flows used in financing activities			
Proceeds from debt	47,000	—	47,000
Repayments of debt	(59,000)	—	(59,000)
Debt and equity financing costs	(11)	—	(11)

Net cash flows used in financing activities	(12,011)	—	(12,011)
Net decrease in cash and cash equivalents	(37)	—	(37)
Cash and equivalents beginning of period	37	—	37
Cash and equivalents end of period	$ —	$ —	$ —

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

Restatement of Previously Issued Consolidated Financial Statements

Management's Discussion and Analysis of Financial Condition and Results of Operations has been updated to reflect the effects of the restatement described in Note 13 of the Consolidated Financial Statements in Item 1 of this quarterly report.

Overview

We are an independent oil and natural gas company engaged in the acquisition, exploration, development, production and gathering of crude oil and natural gas. Our primary production activity is focused in the Cherokee Basin, a 15-county region in southeastern Kansas and northeastern Oklahoma, and Central Oklahoma. We also have minor oil and natural gas producing properties in the Appalachian Basin. Our Cherokee Basin and Central Oklahoma properties comprise our MidContinent area of operations.

The following discussion should be read together with the unaudited condensed consolidated financial statements and related notes included elsewhere herein and with our annual report on Form 10-K for the year ended December 31, 2014.

Operations and Production Update

Corporate and Operational – In response to the collapse of oil and natural gas prices that began in the latter half of 2014, the Company reduced its Oklahoma City staff by nearly 25% and its field staff by nearly 20% in January and February 2015. Additionally, the Company implemented another nearly 50% reduction to its remaining Oklahoma City staff in October 2015, which is expected to reduce operating costs by an additional $4 million over the next twelve months. Excluding costs related to these reductions, operating costs, including lease operating, gathering and general and administrative expenses, for the first nine months of 2015, were $33 million, or 12.6%, lower than the same period last year.

During the third quarter of 2015, the Company recorded an additional impairment to its oil and natural gas properties of $34.9 million, bringing the total impairment in 2015 to $74.3 million. These impairments were the result of the ceiling test performed as required under the full cost method of accounting for oil and natural gas properties. At current NYMEX oil and natural gas forward prices, management expects to record between $20 and $25 million of additional impairments to the carrying value of the Company's oil and natural gas properties in the fourth quarter of 2015.

The Company's borrowing base under its senior secured revolving credit facility was re-determined on June 24, 2015. In connection with the redetermination, the Company entered into an amendment to its senior secured revolving credit facility, which among other things, reduced the borrowing base to $76 million as a result of the redetermination and established a six-month schedule for the repayment or reduction of the resulting $10.4 million borrowing base deficiency by December 22, 2015. Our next borrowing base redetermination will be effective in November 2015, at which time the Company expects further significant reductions. Subsequent to the May redetermination the Company has settled 59% of its 2016 oil and natural gas hedge contracts and used the proceeds