

ReoStar Energy CORP  
Form 10QSB  
August 14, 2007

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**FORM 10-QSB**

Quarterly report under Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2007.

Transition report under Section 13 or 15(d) of the Securities Exchange Act of 1934

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

Commission File Number 000-52316

**REOSTAR ENERGY CORPORATION**

Name of small business issuer in its charter

**Nevada**  
(State or other jurisdiction of  
incorporation)

**20-8428738**  
(IRS Employer Identification No.)

**3880 Hulen Avenue, Fort Worth, Texas 76107**

(Address of principal executive offices)

**(817) 989-7367**

(Registrant's telephone number)

**5416 Birchman Ave, Fort Worth, Texas 76107**

(Former name, former address and former fiscal year, if changed since last report)

Check whether the issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

| <u>Class</u>                              | <u>Outstanding at August 10, 2007</u> |
|---|---------------------------------------|
| Common Stock, par value \$0.001 per share | 79,591,310                            |

**REOSTAR ENERGY CORPORATION**

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## REOSTAR ENERGY CORPORATION

## PART I - FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

**ReoStar Energy Corporation**  
**Consolidated Balance Sheet**  
**June 30, 2007**  
**(unaudited)**

**ASSETS**

|  |               |
|--|---------------|
| Current Assets:                                    |               |
| Cash   | \$ 6,830,277  |
| Accounts Receivable:                               |               |
| Oil and Gas  | 504,587       |
| Related Party                                      | 351,092       |
| Total Current Assets                               | 7,685,956     |
| Note Receivable                                    | 1,532,767     |
| Oil and Gas Properties - successful efforts method | 12,673,354    |
| Less Accumulated Depletion and Depreciation        | (3,024,565)   |
| Oil and Gas Properties (net)                       | 9,648,789     |
| Other Depreciable Assets:                          |               |
| Less Accumulated Depreciation                      | (1,609)       |
| Other Depreciable Assets (net)                     | 917,070       |
| Total Assets                                       | \$ 19,784,582 |

**LIABILITIES**

|                                       |             |
|---------------------------------------|-------------|
| Current Liabilities:                  |             |
| Accounts Payable                      | \$ 102,438  |
| Payable to Related Parties            | 943,325     |
| Accrued Expenses                      | 960,531     |
| Current Portion of Long-Term Debt     | 3,474,194   |
| Total Current Liabilities             | 5,480,488   |
| Notes Payable                         | 1,690,937   |
| Notes Payable - Related Parties       | 3,618,924   |
| Less Current Portion of Notes Payable | (3,474,194) |
| Total Long-Term Debt                  | 1,835,667   |
| Deferred Tax Liability                | 2,418,463   |
| Total Liabilities                     | 9,734,618   |
| Minority Interest in Pipeline         | 958,584     |
| Commitments and Contingencies:        | -           |

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|  |               |
|--|---------------|
| Contingent Stock Based Compensation  | 144,070       |
| <b>Stockholders' Equity</b>  |               |
| Common Stock, \$.001 par, 200,000,000 shares authorized 79,591,310 shares outstanding on June 30, 2007 | 79,591        |
| Additional Paid-In-Capital   | 8,848,512     |
| Retained Earnings  | 19,207        |
| Total Stockholders' Equity   | 8,947,310     |
| Total Liabilities and Stockholders' Equity   | \$ 19,784,582 |

See Accompanying Notes to Financial Statements

**ReoStar Energy Corporation**  
**Consolidated Statements of Operations**

|  | Three Months Ended           |                             | Twelve Months Ended            |
|--|------------------------------|-----------------------------|--------------------------------|
|  | June 30, 2007<br>(unaudited) | March 31, 2007<br>(audited) | December 31, 2006<br>(audited) |
| <b>Revenues</b>  |                              |                             |                                |
| Oil and Gas Sales  | \$ 813,924                   | \$ 814,400                  | \$ 2,874,291                   |
| Sale of Leases   | -                            | 19,431                      | 400,378                        |
| Other Income   | 65                           | 95,388                      | 45,771                         |
| Total Revenue  | 813,989                      | 929,219                     | 3,320,440                      |
| <b>Costs and Expenses</b>  |                              |                             |                                |
| Oil & Gas Lease Operating Expenses   | 333,521                      | 168,346                     | 1,131,502                      |
| Severance and Ad Valorem Taxes   | 48,936                       | 40,962                      | 163,523                        |
| Delay Rentals  | 43,615                       | -                           | -                              |
| Depletion & Depreciation   | 286,131                      | 372,256                     | 1,856,365                      |
| General & Administrative:  | 450,743                      | 135,947                     | 281,727                        |
| Interest, net of capitalized interest of \$141,012 and \$113,706 for the periods ended 6/30/2007 and 3/31/2007, respectively | -                            | 63,321                      | 13,660                         |
| Total Costs and Expenses   | 1,162,946                    | 780,832                     | 3,446,777                      |
| Income from continuing operations before income taxes  | (348,957)                    | 148,387                     | (126,337)                      |
| Income from discontinued operations:   |                              |                             |                                |
| Pipeline Income  | 35,277                       | 69,156                      | 319,093                        |
| Gain on Sale of Pipeline   | 2,244,349                    | -                           | -                              |
| Income from discontinued operations  | 2,279,626                    | 69,156                      | 319,093                        |
| Interest Income  | 23,332                       | 55,811                      | -                              |
| Income Tax Provision   | (683,900)                    | (1,421,148)                 | -                              |
| Net (Loss) Income  | \$ 1,270,101                 | \$ (1,147,794)              | \$ 192,756                     |
| <b>Basic and Diluted Loss per Common Share</b>   | \$ 0.02                      | \$ (0.02)                   |                                |
| <b>Weighted Average Common Shares Outstanding</b>  | 76,524,026                   | 69,616,786                  |                                |
| <b>Pro-Forma Earnings Per Share</b>  |                              |                             |                                |
| Net Income   |                              |                             | \$ 192,756                     |
| Proforma Income Tax Expense at Statutory Rate (35%)  |                              |                             | (67,465)                       |
| Proforma Net Income  |                              |                             | \$ 125,291                     |
| <b>Proforma Weighted Average Shares Outstanding</b>  |                              |                             | 68,129,310                     |
| <b>Proforma Basic and Diluted Earnings Per Share</b>   |                              |                             | \$ 0.00                        |

See Accompanying Notes to Financial Statements



**ReoStar Energy Corporation**  
**(Formerly Goldrange Resources, Inc.)**  
**Consolidated Statements of Cash Flows**

|  | <b>Three Months Ended</b> |                       | <b>Year Ended</b>        |
|--|---------------------------|-----------------------|--------------------------|
|  | <b>June 30, 2007</b>      | <b>March 31, 2007</b> | <b>December 31, 2006</b> |
|  | <b>(unaudited)</b>        | <b>(audited)</b>      | <b>(audited)</b>         |
| <b>Operating Activities:</b>   |                           |                       |                          |
| Net (Loss) Income  | \$ 1,270,101              | \$ (1,147,794)        | \$ 192,756               |
| Adjustments to reconcile net cash from operating activities:                 |                           |                       |                          |
| Income Tax Expense   | 683,900                   | 1,421,148             | -                        |
| Depletion, Depreciation, & Amortization                                      | 286,131                   | 372,256               | 1,856,365                |
| Note Accretion   | 35,000                    | 41,487                | 128,334                  |
| Stock included in compensation   | 144,070                   | -                     | -                        |
| Changes in Operating Assets and Liabilities                                  |                           | -                     | -                        |
| Cash Overdraft   | -                         | -                     | 186,912                  |
| Changes in Other Assets  | -                         | 13,454                | (13,455)                 |
| Changes in Accrued Liabilities   | 37,027                    | -                     | 86,667                   |
| Change in Related Party Receivables/Payables                                 | 25,902                    | (516,714)             | (543,483)                |
| Changes in Other Receivables   | 63,389                    | (63,389)              | 2,324                    |
| Change in Revenue Receivables  | (9,387)                   | (495,201)             | 86,762                   |
| Changes in Accounts Payable  | (193,131)                 | 704,151               | -                        |
| Net Cash provided from operating activities                                  | 2,343,002                 | 329,398               | 1,983,182                |
| Net Cash provided (used) from discontinued operations                        | 4,964,152                 | (1,479,639)           | (1,770,835)              |
| Net Cash provided (used) by operating activities and discontinued operations | 7,307,154                 | (1,150,241)           | 212,347                  |
| <b>Investing Activities:</b>   |                           |                       |                          |
| Oil & Gas Drilling, Completing and Leasehold Acquisition Costs               | (960,681)                 | (2,091,787)           | (6,371,739)              |
| Change in Drilling Reimbursements in Excess of Costs                         | -                         | (1,962,407)           | 492,160                  |
| Change in Related Party Payable related to drilling                          | (3,826,575)               | -                     | 2,220,498                |
| Deposits   | -                         | -                     | 200,000                  |
| Investment in Other Depreciable Assets                                       | (918,679)                 | -                     | -                        |
| Note Receivable Collections  | 81,451                    | 987,022               | -                        |
| Net Cash used in investing activities  | (5,624,484)               | (3,067,172)           | (3,459,081)              |
| <b>Financing Activities</b>  |                           |                       |                          |
| Notes Payable (Payments) Advances  | (1,950,000)               | 999,667               | 704,466                  |
| Changes in Notes Payable Related Party                                       | -                         | -                     | 1,264,957                |
| Net cash received from common stock subscriptions                            | 6,885,353                 | 3,430,000             | -                        |
| Net Cash provided from financing activities.                                 | 4,935,353                 | 4,429,667             | 1,969,423                |
| Net Increase in cash   | 6,618,023                 | 212,254               | (1,263,552)              |
| Cash - Beginning of the period   | 212,254                   | -                     | 1,263,552                |
| Cash - End of the period   | \$ 6,830,277              | \$ 212,254            | \$ -                     |

See Accompanying Notes to Financial Statements





**ReoStar Energy Corporation**  
**Consolidated Statements of Cash Flows**  
(Continued)

|   | Three Months Ended           |                             | Year Ended                     |
|---|------------------------------|-----------------------------|--------------------------------|
|   | June 30, 2007<br>(unaudited) | March 31, 2007<br>(audited) | December 31, 2006<br>(audited) |
| <b>Supplemental Disclosure of Cash Flow Information</b> |                              |                             |                                |
| Cash paid during period for:                            |                              |                             |                                |
| Interest  | \$ 59,993                    | \$ 73,234                   | \$ 185,284                     |
| Income Taxes  | -                            | -                           | -                              |
| <b>Non Cash Investing and Financing Activities</b>      |                              |                             |                                |
| Contribution of Note Receivable                         | \$ -                         | \$ 2,601,240                | \$ -                           |
| Contribution of Note Payable                            | \$ -                         | \$ (1,950,000)              | \$ -                           |
| Conversion of Note Payable to Minority Interest         | \$ -                         | \$ (1,490,000)              | \$ -                           |
| Contribution of Related Party Receivable/Payables       | \$ -                         | \$ 651,240                  | \$ -                           |

See Accompanying Notes to Financial Statements

**REOSTAR ENERGY CORPORATION  
(FORMERLY GOLDRANGE RESOURCES, INC.)  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(1) BASIS OF PRESENTATION**

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principals for interim financial information and pursuant to the rules and regulations of the United States Securities and Exchange Commission. They do not include all information and notes required by generally accepted accounting principals for complete financial statements. However, except as disclosed, there has been no material change in the information disclosed in the notes to financial statements included in the Annual Report on Form 10-KSB of ReoStar Energy Corporation for the year ended March 31, 2007. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three-month period ended June 30, 2007, are not necessarily indicative of the results that may be expected for the year ending March 31, 2008. The financial statements and notes are representations of the Company's management who are responsible for their integrity and objectivity. The Company's accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of these financial statements.

**(2) CAPITAL STOCK**

We have authorized capital stock of 200 million shares of common stock.

The following is a schedule of changes in the number of outstanding common shares since March 31, 2007

|                                  | Quarter Ended<br>June 30, 2007 |
|----------------------------------|--------------------------------|
| Beginning Balance                | 71,954,262                     |
| Private Placement shares issued  | 7,636,551                      |
| Shares outstanding June 30, 2007 | 79,590,813                     |

We closed the private placement offering in April 2007. Shares sold via the private placement offering totaled 11,462,000 at \$1.00 per share.

Each share had one warrant attached with a strike price of \$1.50 per share. The warrants are scheduled to expire 2 years from the date the stock certificates are issued.

On April 1, 2007, ReoStar entered into employment contracts with certain key employees. In conjunction with the employment contracts, the company approved the issuance of 700,000 shares of restricted stock. 350,000 of the shares vest on March 31, 2008, and the balance of the shares will vest on March 31, 2009. For the quarter ended June 30, 2007, Salaries and Benefits included costs of \$144,070 related to restricted stock and a liability of an equal amount was recorded as a contingent stock based compensation liability.

On April 1, 2007, ReoStar also entered into a stock option arrangement with two outside members of its board of directors. Both board members received stock options of 50,000 shares, one-third of which will vest annually on March 31 2008, 2009, and 2010. For the quarter ended June 30, 2007, other General & Administrative expenses included costs of \$9,845 related to the stock options.

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The estimated compensation expense related to the restricted stock grant and stock option grants for the following three year period is shown in the table below:

|                               | Year Ending March 31 |            |          |
|-------------------------------|----------------------|------------|----------|
|                               | 2008                 | 2009       | 2010     |
| Restricted Stock Compensation | \$ 581,137           | \$ 195,336 | \$ -     |
| Stock Option Compensation     | 39,382               | 21,256     | 9,232    |
|                               | \$ 620,519           | \$ 216,592 | \$ 9,232 |

### (3) DISCONTINUED OPERATIONS

Effective May 1, 2007 we sold our entire interest in the Tri-County Gas Gathering System. The sales price was \$15,000,000. The proceeds from the sale were reduced \$900,000 for outstanding capital calls. The purchase and sales agreement provided for \$1.6 million of the proceeds to be escrowed for ninety days. The balance of the proceeds (\$12.5 million) were received in June. The following table reflects the calculation of gain from the sale.

|   | June 30, 2007 |
|---|---------------|
| Total Proceeds                              | \$ 15,000,000 |
| Closing adjustment for unpaid capital calls | (900,000)     |
| Net Proceeds                                | 14,100,000    |
| Basis in the pipeline                       | (8,827,299)   |
| Gain on sale                                | \$ 5,272,701  |

The following table reflects the changes to the minority interest in our investment in the pipeline for the three months ending June 30, 2007 and March 31, 2007:

|  | Three Months<br>Ended<br>June 30, 2007 | Three Months<br>Ended<br>March 31, 2007 |
|--|--|---|
| Minority Interest at beginning of the quarter          | \$ 4,685,301                           | \$ 2,316,205                            |
| Conversion of Note Payable to Minority Interest Equity | -                                      | 1,490,000                               |
| Capital Contributions                                  | 144,446                                | 772,820                                 |
| Operating Income Allocation                            | 48,328                                 | 106,276                                 |
| Allocation of Gain on Sale                             | 3,024,120                              | -                                       |
| Cash Distributions                                     | (6,943,611)                            | -                                       |
| Minority Interest at March 31, 2007                    | \$ 958,584                             | \$ 4,685,301                            |

In connection with the conversion of the note payable to minority interest equity, the joint venture partners waived the \$95,338 in accrued interest related to the note. This amount has been included in other income at March 31, 2007.

### (4) OTHER DEPRECIABLE ASSETS

In June 2007, ReoStar formed a wholly owned subsidiary, ReoStar Leasing, Inc. ("RLI"), a Texas corporation. RLI acquired a workover drilling rig and a swab rig near the end of June. In July, RLI began leasing the rigs to the related party operator of its Barnett Shale properties. The drilling rigs were included in other depreciable assets on June 30, 2007. The following table summarizes the other depreciable asset holdings at period end.

|                                | June 30, 2007 |         |
|--------------------------------|---------------|---------|
| Workover Drilling Rig          | \$            | 676,491 |
| Swab Rig                       |               | 175,000 |
| Other                          |               | 67,188  |
| Total Other Depreciable Assets | \$            | 918,679 |

**(5) SUBSEQUENT EVENTS**

In late June, ReoStar formed a wholly owned subsidiary, ReoStar Gathering, Inc. ("RGI"), a Texas corporation. In July, RGI began oil gathering operations in our Corsicana field.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION**

*In addition to historical information, the following information contains forward-looking statements as defined under federal securities laws. These statements are based on current expectations, estimates and projections about the industry and markets in which ReoStar Energy Corporation operates, and management's beliefs and assumptions. Forward-looking statements are not guarantees of future performance and involve certain known and unknown risks and uncertainties that could cause actual results to differ materially from those expressed or implied by such statements. Such risks and uncertainties include, but are not limited to, changes in local, regional, and national economic and political conditions, the effect of governmental regulation, competitive market conditions, our ability to achieve expected results from our operations, our ability to obtain additional financing, and other risks detailed herein and from time to time in our SEC reports. The following discussion should be read in conjunction with the accompanying financial statements and notes thereto appearing elsewhere herein.*

Our company was incorporated in the State of Nevada on November 29, 2004 under the name of "Goldrange Resources, Inc."

On February 1, 2007, Goldrange Resources entered into a Contribution Agreement with JMT Resources, Ltd., REO Energy, Ltd., and Benco Operating, Inc., pursuant to which Goldrange Resources acquired (1) certain assets related to oil and gas properties, and other related rights; (2) a Note Receivable from REO Energy Ltd.'s drilling contractor which is secured by the drilling rig dedicated to REO Energy Ltd.'s acreage; (3) a 30% fractional interest in a natural gas pipeline and gas gathering system; and (4) debt aggregating approximately \$14,250,000 in exchange for the issuance of an aggregate of 54,750,000 shares of its common stock to the contributors.

The contributing entities were under common control prior to the transaction, and immediately after the transactions, the former shareholders of the contributing entities owned 80.4% of the issued and outstanding stock of the company. The contribution has been accounted for as a reverse merger. Goldrange Resources, Inc. has a March 31 fiscal year end while the contributing companies each had a calendar year end.

In order to provide comparative data throughout this quarterly report, when financial information is presented, we have provided information for the quarters ended June 30, 2007 and March 31, 2007. In addition, annual data is presented comprised of the combined predecessor companies calendar year ended December 31, 2006.

On February 5, 2007, we changed our name to "ReoStar Energy Corporation."

**Overview of Our Business**

We are an independent natural gas and oil company engaged in the exploration, development and acquisition of oil and gas properties, primarily in the Mid-Continent Region of the United States.

ReoStar's development strategy is to acquire acreage position in resource plays such as the Barnett Shale in North Texas and acreage in mature oil fields that provide the opportunity to increase production through secondary or tertiary recovery techniques. Our objective is to increase reserves and production through internally generated drilling projects coupled with complementary acquisitions. Further, we evaluate various Enhanced Oil Recovery (EOR) techniques to optimize exploitation of mature oil holdings.

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In June 2007, we acquired a work-over rig and a swab rig. We believe these acquisitions will allow us to significantly lower completion and operating costs by not having to procure this equipment on an hourly basis from third-party vendors.

Our website address is <http://www.reostarenergy.com>.

### **Near-Term Plans**

**Barnett Shale:** We will bring three of the wells that were in process on June 30 online during the second quarter. We intend to begin a close proximity "cluster" re-completion and infill drilling program in our Barnett Shale properties. During the second quarter, we expect to drill 4 new wells and re-complete 4 older wells. All eight wells will be fractured using high pressure stimulation within a ten-day period and be brought online simultaneously.

**Corsicana:** We began injecting a polymer-surfactant solution into our pilot area in mid-June. During the second quarter we will closely monitor the injection process and expect to begin to see results during the fourth quarter of this fiscal year. We will also begin to finalize plans for the expansion of pilot project to other areas of the field we own.

### **Long-Term Plans**

**Barnett Shale:** We expect to continue the cluster drilling and re-completion program through the end of our fiscal year. We will drill approximately 10 new wells and will re-complete 5-10 older wells during the third and fourth quarter of the fiscal year. Funding for program will be provided by operations and working interest partners.

We will continue to monitor the results of our new drilling and completion techniques. If the results warrant, we may acquire additional acreage near our existing production.

**Corsicana:** We expect to initiate phase two of the pilot project during the third and fourth quarters of this fiscal year. This phase might require another polymer mixing plant; however, we will be required to drill several new production and injection wells. Funding for this phase will be achieved partially through the Company's resources and might require additional outside capital. Management is considering its options with regards to such funding, which could be as much as \$3 million, however, as the redevelopment program progresses, we expect the remaining capital requirements will be derived from the project's cash flow. There is no guarantee that such outside capital will be available to us or, if available, it will be on terms acceptable to us.

### **Successful Efforts Method of Accounting**

We account for our exploration and development activities utilizing the successful efforts method of accounting. Under this method, costs of productive exploratory wells, development dry holes and productive wells and undeveloped leases are capitalized. Oil and natural gas lease acquisition costs are also capitalized. Exploration costs, including personnel costs, certain geological and geophysical expenses and delay rentals for oil and natural gas leases, are charged to expense as incurred. Exploratory drilling costs are initially capitalized, but charged to expense if and when the well is determined not to have found reserves in commercial quantities. The sale of a partial interest in a proved property is accounted for as a cost recovery and no gain or loss is recognized as long as this treatment does not significantly affect the unit-of-production amortization rate. A gain or loss is recognized for all other sales of producing properties.

The application of the successful efforts method of accounting requires managerial judgment to determine the proper classification of wells designated as developmental or exploratory which will ultimately determine the proper accounting treatment of the costs incurred. The results from a drilling operation can take considerable time to analyze and the determination that commercial reserves have been discovered requires both judgment and industry experience. Wells may be completed that are assumed to be productive and actually deliver oil and natural gas in quantities insufficient to be economic, which may result in the abandonment of the wells at a later date. The evaluation of oil and natural gas leasehold acquisition costs requires managerial judgment to estimate the fair value of these costs with reference to drilling activity in a given area.

The successful efforts method of accounting can have a significant impact on the operational results reported when we enter a new exploratory area in hopes of finding an oil and natural gas field that will be the focus of future developmental drilling activity. The initial exploratory wells may be unsuccessful and will be expensed. Seismic costs can be substantial which will result in additional exploration expenses when incurred.

#### **Industry Environment**

We operate entirely within the United States, a mature region for the exploration and production of oil and gas. The size and frequency of new discoveries of oil and gas in the United States are declining, while finding and development costs are increasing.

We believe that there remain certain areas in the Mid-Continent Region which are under-explored or have not been fully explored and developed with the benefit of newly available exploration, production and reserve enhancement technology. Examples of such technology include advanced 3-D seismic processing, hydraulic reservoir fracture stimulation, advances in well logging and analysis, and enhanced oil recovery practices.

Another characteristic of a mature region is the historical exit of larger independent producers and major oil companies from such regions. These companies have ventured increasingly overseas and offshore, de-emphasizing their onshore United States assets. This movement out of mature basins with significant proven reserves has provided acquisition opportunities for well managed companies that are capable of quickly analyzing opportunities, well positioned financially to quickly close an acquisition, and have the technical expertise to generate additional value from these assets.

In other situations, to increase cash flow without increasing capital spending, larger independent producers and major integrated oil companies have allowed smaller companies the opportunity to explore and develop reserves on their undeveloped acreage through joint ventures and farm-in arrangements.

We believe the acquisition market for natural gas properties has become extremely competitive as producers vie for additional production and expanded drilling opportunities. Acquisition values have reached historic highs and we expect these values to remain high in the near future. We expect drilling and service costs pressures to ease slightly, but expect them to remain at a high level in relative to past pricing. In addition, we expect lease operating expenses to continue to rise as producers are forced to make operational enhancements to maintain production in aging fields.

Crude oil and natural gas are commodities. The price that we receive for the crude oil and natural gas we produce is largely a function of market supply and demand. Demand for natural gas in the United States has increased dramatically over the last ten years. Demand is impacted by general economic conditions, estimates of gas in storage, weather and other seasonal condition, including hurricanes and tropical storms. Demand for crude oil has also increased over the last ten years while the increase in supply has not increased proportionately resulting in a tight market. Market conditions involving over or under supply of crude oil and natural gas can result in substantial price volatility. Historically, commodity prices have been volatile and we expect the volatility to continue in the future. A substantial or extended decline in oil and gas prices or poor drilling results could have a material adverse effect on our financial position, results of operations, cash flows, quantities of oil and gas reserves that may be economically produced and our ability to access capital markets.

We derive our revenues from the sale of crude oil and natural gas that is produced from our properties. Revenues are a function of the volume produced and the prevailing market price at the time of sale. The price of oil and natural gas is the primary factor affecting our revenues.

#### **Principal Components of Our Cost Structure**

*Direct Operating Expenses.* These are day-to-day costs incurred to bring hydrocarbons out of the ground and to the market together with the daily costs incurred to maintain our producing properties. Such costs also include work-over repairs to our oil and gas properties not covered by insurance. To minimize and help control our costs, we acquired one work-over drilling rig and one swab rig in June of 2007.

*Production and Ad Valorem Taxes.* These costs are primarily paid based on a percentage of market prices or at fixed rates established by federal, state or local taxing authorities.

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*Exploration Expense.* The costs include geological and geophysical costs, seismic costs, delay rentals and the costs of unsuccessful wells or dry holes. While our current asset mix requires a minimum of geological and geophysical costs and seismic costs, it is possible this component of our cost structure could sharply increase depending upon future property acquisitions.

*Plugging Costs.* The Corsicana field is over one hundred years old and has hundreds of abandoned well bores scattered throughout the properties. In order to properly execute our enhanced oil recovery projects, we will plug these abandoned, well bores that have no mechanical integrity. Since the wells are shallow, we are able to plug the well bore at a cost of less than \$1,500 per well.

*General and Administrative Expense.* Overhead, including payroll and benefits for our corporate staff, costs of maintaining our headquarters, costs of finding our working interest partners, costs of managing our production and development operations, audit and other professional fees and legal compliance are included in general and administrative expense. General and administrative expense includes stock-based compensation expense (non-cash) associated with the adoption of SFAS No. 123(R), amortization of restricted stock grants as part of employee compensation.

*Interest.* We may finance a portion of our working capital requirements and acquisitions with borrowings under a credit facility or with longer term public traded debt securities. As a result, interest expense could become a much more prevalent component of our cost structure. Currently we capitalize all interest associated with acquiring and developing our oil and gas properties.

*Depreciation, Depletion and Amortization.* As a successful efforts company, we capitalize all costs associated with our acquisition and all successful development and exploration efforts, and apportion these costs to each unit of production through depreciation, depletion and amortization expense. This also includes the systematic, monthly amortization of capitalized interest.

*Income Taxes.* We are subject to state and federal income taxes but are currently not in a minimal tax paying position for regular federal income taxes, primarily due to the current deductibility of intangible drilling costs ("IDC"). We are also subject to some state income taxes. Currently, virtually all of our federal taxes are deferred; however, at some point, we will utilize all of our net operating loss carry-forwards and we will recognize current income tax expense and continue to recognize current tax expense as long as we are generating taxable income.

### ***Results and Analysis of Financial Condition, Cash Flows and Liquidity***

During the quarter ended June 30, 2007, we sold 18,286 barrels of oil equivalent ("BOE") compared with 16,603 BOE for the previous quarter. The average price for natural gas sold during the quarter was \$5.95 per MCF. The average price per barrel of oil was \$62.00.

During the quarter, we sold our entire interest in the Tri-County Gas Gathering System for \$14.1 million net of closing adjustments. The sale resulted in an after tax gain (net of minority interest) of approximately \$1.5 million. See Note 12 of the financial statements for more detail. The 8-K filed on June 7 is incorporated herein by reference.

During fiscal quarter ended June 30, 2007, we spent \$5.8 million on capital expenditures. We also raised approximately \$5 million from the sale of our pipeline. Financing activities included raising \$6.8 million through the sale of our stock via a private placement offering and paying down notes of \$1.95 million. The private placement offering closed on April 30, 2007. In total, the Company raised approximately \$11.5 million in gross proceeds from the private placement.

On June 30, 2007, we had \$6.8 million in cash and total assets of \$19.8 million. Debt consisted of payables to non-related parties of \$2.8 million of which 1.6 million is long-term. We also had accounts and notes payables to related parties of \$6 million.

Cash is required to fund capital expenditures necessary to offset inherent declines in production and reserves (which is typical in the oil and gas industry). The future success of increasing reserves and production will be dependent on capital resources available and the success of finding or acquiring additional reserves. We believe that net cash generated from operating activities and the proceeds from our private placement offering will be adequate to satisfy near-term financial obligations and liquidity needs.



However, long-term cash flows are subject to a number of variables including the level of production and prices as well as various economic conditions that have historically affected the oil and gas business. A material drop in oil and gas prices or a reduction in production and reserves would reduce our ability to fund capital expenditures, meet financial obligations and remain profitable. We operate in an environment with numerous financial and operating risks, including, but not limited to, the inherent risks of the search for, development and production of oil and gas, the ability to buy properties and sell production at prices which provide an attractive return and the highly competitive nature of the industry. Our ability to expand our reserve base is, in part, dependent on obtaining sufficient capital through internal cash flow, bank borrowings or the issuance of debt or equity securities. There can be no assurance that internal cash flow and other capital sources will provide sufficient funds to maintain capital expenditures that we believe are necessary to efficiently develop our properties and offset inherent declines in production and proved reserves.

#### ***Cash Flow***

Our principal sources of cash are operating cash flow, the sale of a portion of the working interest in our Barnett Shale drilling projects, and the issuance of equity securities. Our operating cash flow is highly dependent on oil and gas prices.

Based on current projections and oil and gas futures prices, the 2007 capital program is expected to be funded with internal cash flow and asset sales.

#### ***Capital Requirements***

Our primary needs for cash are for exploration and development of our Barnett Shale properties, establishing the enhanced oil recovery projects in our Corsicana properties, and the acquisition of additional oil and gas properties, both in unconventional gas plays and re-development of mature fields. During the year ended December 31, 2006, a predecessor company, REO Energy, Ltd. expended approximately \$24 million on Barnett drilling projects. During the three months ended June 30, 2007 and March 31, 2007, respectively, \$4.7 million and \$4.5 million of capital was expended on Barnett Shale drilling projects. The Barnett Shale capital program was funded in part via the sale of working interests on a turn-key basis, resulting in a working interest for the Company. Our share of the Barnett Shale capital program was funded by cash flow from the Barnett Shale properties.

We expect to initiate phase two of the Corsicana pilot project during the third and fourth quarters of this fiscal year. This phase might require another polymer mixing plant; however, we will be required to drill several new production and injection wells. Funding for this phase will be achieved partially through the Company's resources and might require additional outside capital. Management is considering its options with regards to such funding, which could be as much as \$3 million, however, as the redevelopment program progresses, we expect the remaining capital requirements will be derived from the project's cash flow. There is no guarantee that such outside capital will be available to us or, if available, it will be on terms acceptable to us.

**Cautionary Statement:** There can be no assurance that we will be successful in raising capital through private placements or otherwise. Even if we are successful in raising capital through the sources specified, there can be no assurances that any such financing would be available in a timely manner or on terms acceptable to us and our current shareholders. Additional equity financing could be dilutive to our then existing shareholders, and any debt financing could involve restrictive covenants with respect to future capital raising activities and other financial and operational matters.

#### ***Future Commitments***

In addition to our capital expenditure program, we are committed to making cash payments in the future on two types of contracts: note agreements and operating leases. As of June 30, 2007, we do not have any capital leases nor have we entered into any material long-term contracts for equipment, nor do we have any off-balance sheet debt or other such unrecorded obligations.

The table below provides estimates of the timing of future payments that we are obligated to make based on agreements in place at June 30, 2007. In addition to the contractual obligations listed on the table below, our balance sheet at June 30, 2007 reflects accrued interest payable on our debt of \$189,000 which is payable throughout the rest of 2007.

|                             | Fiscal year ended March 31 |         |         |
|-----------------------------|----------------------------|---------|---------|
|                             | 2008                       | 2009    | 2010    |
| Office Lease                | 111,000                    | 150,000 | 132,000 |
| Mineral Lease loans         | 100,000                    | 100,000 |         |
| 1st State Bank Note         | 79,600                     |         |         |
| Related Party Notes Payable | 3,294,594                  | 324,330 |         |

We expect to refinance the \$3.3 million related party note before the note becomes due.

#### ***Off-Balance Sheet Arrangements***

We do not currently utilize any off-balance sheet arrangements to enhance liquidity and capital resource position, or for any other purpose.

#### ***Inflation and Changes in Prices***

Our revenues, the value of our assets and our ability to obtain bank loans or additional capital on attractive terms have been and will continue to be affected by changes in oil and gas prices and the costs to produce our reserves. Oil and gas prices are subject to significant fluctuations that are beyond our ability to control or predict. Although certain of our costs and expenses are affected by general inflation, inflation does not normally have a significant effect on our business. In a trend that began in 2004 and accelerated during 2005 and 2006, commodity prices for oil and gas increased significantly. The higher prices have led to increased activity in the industry and, consequently, rising costs. These costs trends have put pressure not only on our operating costs but also on our capital costs. We expect a moderation of the level of increases in these costs for fiscal year 2008.

#### **Management's Discussion of Critical Accounting Estimates**

Our discussion and analysis of our financial condition and results of operations are based upon consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of our financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at year-end and the reported amounts of revenues and expenses during the year. We base our estimates on historical experience and various other assumptions that we believe are reasonable; however, actual results may differ.

Certain accounting estimates are considered to be critical if (a) the nature of the estimates and assumptions is material due to the level of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to changes; and (b) the impact of the estimates and assumptions on financial condition or operating performance is material.

#### ***Oil and Gas Properties***

To ensure the reliability of our reserve estimates, we engage independent petroleum consultants to prepare an estimate of proved reserves. Proved reserves are defined by the SEC as those volumes of crude oil, condensate, natural gas liquids and natural gas that geological and engineering data demonstrate with reasonable certainty are recoverable from known reservoirs under existing economic and operating conditions. Proved developed reserves are volumes expected to be recovered through existing wells with existing equipment and operating methods. Although our engineers are knowledgeable of and follow the guidelines for reserves established by the SEC, the estimation of reserves requires engineers to make a significant number of assumptions based on professional judgment. Reserve estimates are updated at least annually and consider recent production levels and other technical information. Estimated reserves are often subject to future revisions, which could be substantial, based on the availability of additional information, including: reservoir performance, new geological and geophysical data, additional drilling, technological advancements, price and cost changes and other economic factors. Changes in oil and gas prices can lead to a decision to start-up or shut-in production, which can lead to revisions to reserve quantities. Reserve revisions in turn cause adjustments in the depletion rates utilized by us. We cannot predict what reserve revisions may be required in future periods.

We monitor our long-lived assets recorded in property, plant and equipment in our consolidated balance sheet to ensure they are fairly presented. We must evaluate our properties for potential impairment when circumstances indicate that the carrying value of an asset could exceed its fair value. A significant amount of judgment is involved in performing these evaluations since the results are based on estimated future events. Such events include a projection of future oil and natural gas sales prices, an estimate of the ultimate amount of recoverable oil and gas reserves that will be produced from a field, the timing of future production, future production costs, future abandonment costs, and future inflation. The need to test a property for impairment can be based on several factors, including a significant reduction in sales prices for oil and/or gas, unfavorable adjustment to reserves, physical damage to production equipment and facilities, a change in costs, or other changes to contracts, environmental regulations or tax laws. All of these factors must be considered when testing a property's carrying value for impairment. We cannot predict whether impairment charges may be required in the future. We are required to develop estimates of fair value to allocate purchase prices paid to acquire businesses to the assets acquired and liabilities assumed under the purchase method of accounting. The purchase price paid to acquire a business is allocated to its assets and liabilities based on the estimated fair values of the assets acquired and liabilities assumed as of the date of acquisition. We use all available information to make these fair value determinations. See Note 3 to the consolidated financial statements for information on these acquisitions.

#### ***Deferred Taxes***

We are subject to income and other taxes in all areas in which we operate. When recording income tax expense, certain estimates are required because income tax returns are generally filed many months after the close of a calendar year, tax returns are subject to audit which can take years to complete and future events often impact the timing of when income tax expenses and benefits are recognized. We have deferred tax assets relating to tax operating loss carry forwards and other deductible differences. We routinely evaluate deferred tax assets to determine the likelihood of realization. A valuation allowance is recognized on deferred tax assets when we believe that certain of these assets are not likely to be realized. In determining deferred tax liabilities, accounting rules require OCI to be considered, even though such income or loss has not yet been earned.

At June 30, 2007, deferred tax liabilities exceeded deferred tax assets by \$2.4 million. We may be challenged by taxing authorities over the amount and/or timing of recognition of revenues and deductions in our various income tax returns. Although we believe that we have adequately provided for all taxes, gains or losses could occur in the future due to changes in estimates or resolution of outstanding tax matters.

#### ***Contingent Liabilities***

A provision for legal, environmental and other contingent matters is charged to expense when the loss is probable and the cost or range of costs can be reasonably estimated. Judgment is often required to determine when expenses should be recorded for legal, environmental and contingent matters. In addition, we often must estimate the amount of such losses. In many cases, our judgment is based on the input of our legal advisors and on the interpretation of laws and regulations, which can be interpreted differently by regulators and/or the courts. We monitor known and potential legal, environmental and other contingent matters and make our best estimate of when to record losses for these matters based on available information. We currently have no material accruals for contingent liabilities

### **ITEM 3. CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, we conducted an evaluation, under the supervision and with the participation of our chief executive officer and chief financial officer of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")). Based upon this evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. There was no change in our internal controls or in other factors that could affect these controls during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II - OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

We are currently not a party to any pending legal proceeding. From time to time, we may receive claims of and become subject to routine litigation that is incidental to the business.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

From January 2007 through May 2007, we sold to investors in a private placement transaction an aggregate of 11,462,000 units, of our securities. Of the total units issued in the private placement, 7,636,551 units were issued in the period covered by this quarterly report. Each unit consisted of one share of common stock and a warrant to purchase one share of common stock. The purchase price was \$1.00 per unit and we received an aggregate of \$11,462,000 in gross proceeds. The warrants have an exercise period of two years and an exercise price of \$1.50 per share. The securities sold in the private placement were exempt from registration under the Securities Act of 1933, as amended, pursuant to Regulation S promulgated there under. In connection with the private placement, we filed a resale registration statement registering 11,462,000 shares of common stock issued in the private placement and 11,462,000 shares of common stock issuable pursuant to the warrants.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

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

None

**ITEM 5. OTHER INFORMATION**

Please see the information regarding the private placement set forth in Item 2 above.

**ITEM 6. EXHIBITS**

**EXHIBIT  
NUMBER**

**DESCRIPTION**

|      |   |
|------|---|
| 10.1 | Purchase and Sale Agreement by and between ReoStar Energy Corporation and Cimmarron Gathering, LP dated June 6, 2007. (Incorporated by reference to the Form 8-K filed on June 6, 2007) |
| 31.1 | CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 31.2 | CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 32.1 | CEO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 32.2 | CFO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |

**SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

August 14, 2007

REOSTAR ENERGY CORPORATION

By /s/ Mark S. Zouvas

Mark S. Zouvas, Chief Executive Officer

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