GASTAR EXPLORATION LTD
Form 10-Q
May 12, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2008

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE TRANSITION PERIOD FROM _____ TO _____.

Commission file number 001-32714

GASTAR EXPLORATION LTD.

(Exact name of registrant as specified in its charter)

Alberta, Canada **(State or other jurisdiction of** **incorporation or organization)**	**98-0570897** **(IRS Employer Identification No.)**
1331 Lamar Street, Suite **1080 Houston, Texas 77010** **(Address of principal executive offices)**	**77010** **(ZIP Code)**

(713) 739-1800

(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 preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x 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 definition 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 x Non-accelerated filer ¨ 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 x

Total number of common shares, no par value per share, as of May 12, 2008 was 208,194,570.

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GASTAR EXPLORATION LTD.

QUARTERLY REPORT ON FORM 10-Q

FOR THE THREE MONTHS ENDED MARCH 31, 2008

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Unless otherwise indicated or required by the context, (i) we , us , and our refer to Gastar Exploration Ltd. and its subsidiaries and predecessors, (ii) all dollar amounts appearing in this Quarterly Report on Form 10-Q (Form 10-Q) are stated in United States (U.S.) dollars unless specifically noted in Canadian dollars (CDN$) or Australian dollars (AUD$), and (iii) all financial data included in this Form 10-Q has been prepared in accordance with generally accepted accounting principles in the United States of America (US GAAP).

General information about us can be found on our website at www.gastar.com. The information on our website is neither incorporated into, nor part of, this report. Our Annual Reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, as well as any amendments and exhibits to those reports, will be available free of charge through our website as soon as reasonably practicable after we file or furnish them to the United States Securities and Exchange Commission (SEC). Information is also available at www.sec.gov for United States filings and on SEDAR at www.sedar.com for Canadian filings.

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GASTAR EXPLORATION LTD. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS

	March 31, 2008 (Unaudited)	December 31, 2007
	(in thousands)	
CURRENT ASSETS:		
Cash and cash equivalents	$ 78,968	$ 85,854
Accounts receivable, net of allowance for doubtful accounts of $4.3 million for both periods	8,769	4,828
Due from related parties	1,611	904
Prepaid expenses	1,117	1,235
Total current assets	90,465	92,821
PROPERTY, PLANT AND EQUIPMENT:		
Natural gas and oil properties, full cost method of accounting:		
Unproved properties, not being amortized	84,279	69,844
Proved properties	249,490	247,372
Total natural gas and oil properties	333,769	317,216
Furniture and equipment	763	669
Total property, plant and equipment	334,532	317,885
Accumulated depreciation, depletion and amortization	(167,174)	(160,765)
Total property, plant and equipment, net	167,358	157,120
OTHER ASSETS:		
Restricted cash	76	1,074
Deferred charges, net	7,916	8,334
Drilling advances	2,320	2,251
Other assets	150	150
Total other assets	10,462	11,809
TOTAL ASSETS	$ 268,285	$ 261,750

LIABILITIES AND SHAREHOLDERS EQUITY

	March 31, 2008	December 31, 2007
CURRENT LIABILITIES:		
Accounts payable	$ 11,233	$ 12,001
Revenue payable	7,728	6,770
Accrued interest	4,790	1,534
Accrued drilling and operating costs	2,048	2,810
Commodity derivative contracts	5,422	480
Other accrued liabilities	4,306	4,831
Due to related parties	1,865	979
Total current liabilities	37,392	29,405

LONG-TERM LIABILITIES:		
Long-term debt	132,715	132,685
Asset retirement obligation	4,473	4,391
Commodity derivative contracts	545	
Total long-term liabilities	137,733	137,076
COMMITMENTS AND CONTINGENCIES (Footnote 12)		
SHAREHOLDERS EQUITY:		
Common stock, no par value, unlimited shares authorized, 208,204,570 and 208,194,570 common shares issued and outstanding at March 31, 2008 and December 31, 2007, respectively	249,980	249,980
Additional paid-in capital	15,222	14,366
Accumulated other comprehensive loss fair value of commodity hedging	(4,554)	(480)
Accumulated other comprehensive loss foreign exchange	(7)	(29)
Accumulated deficit	(167,481)	(168,568)
Total shareholders equity	93,160	95,269
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 268,285	$ 261,750

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

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GASTAR EXPLORATION LTD. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	For the Three Months Ended March 31, 2008	2007
	(in thousands, except shares and per share data)	
REVENUES:		
Natural gas and oil revenues	$ 16,846	$ 7,515
Unrealized natural gas hedge loss	(1,413)	
Total revenues	15,433	7,515
EXPENSES:		
Production taxes	269	294
Lease operating expenses	1,542	1,695
Transportation and treating	459	323
Depreciation, depletion and amortization	6,409	4,341
Accretion of asset retirement obligation	82	66
Mineral resource properties		13
General and administrative expenses	4,275	6,792
Litigation settlement expense		1,365
Total expenses	13,036	14,889
INCOME (LOSS) FROM OPERATIONS	2,397	(7,374)
OTHER (EXPENSES) INCOME:		
Interest expense	(2,096)	(3,943)
Investment income and other	823	363
Foreign transaction loss	(37)	(1)
INCOME (LOSS) BEFORE INCOME TAXES	1,087	(10,955)
Provision for income taxes		
NET INCOME (LOSS)	$ 1,087	$ (10,955)
NET INCOME (LOSS) PER SHARE:		
Basic and diluted	$ 0.01	$ (0.06)
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:		
Basic and diluted	207,098,570	195,015,561

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

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GASTAR EXPLORATION LTD. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the Three Months Ended March 31, 2008	2007
	(in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 1,087	$ (10,955)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation, depletion and amortization	6,409	4,341
Stock based compensation	856	1,236
Unrealized natural gas hedge loss	1,413	
Amortization of deferred financing costs and debt discount	463	1,077
Accretion of asset retirement obligation	82	66
Changes in operating assets and liabilities:		
Restricted cash for hedging program	1,000	
Accounts receivable	(4,648)	2,298
Prepaid expenses	118	321
Accounts payable and accrued liabilities	7,512	1,897
Net cash provided by operating activities	14,292	281
CASH FLOWS FROM INVESTING ACTIVITIES:		
Development and purchases of natural gas and oil properties	(19,957)	(18,389)
Drilling advances	(1,132)	
Purchase of furniture and equipment	(94)	(15)
Net cash used in investing activities	(21,183)	(18,404)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Increase in restricted cash	(2)	(1)
Deferred financing charges and other	7	
Net cash provided by (used in) financing activities	5	(1)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(6,886)	(18,124)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	85,854	40,733
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 78,968	$ 22,609

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

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GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Summary of Significant Accounting Policies

The accounting policies followed by Gastar Exploration Ltd. (the Company) are set forth in the notes to the Company s audited condensed consolidated financial statements in its Annual Report on Form 10-K for the year ended December 31, 2007. Additionally, refer to the notes to those financial statements for additional details of the Company s financial condition, results of operations and cash flows. All material items included in those notes have not changed except as a result of normal transactions in the interim or as disclosed within this report. The accompanying interim condensed consolidated financial statements have not been audited by independent registered public accountants but, in the opinion of management, reflect all normal and recurring adjustments considered necessary for a fair presentation of the financial position and results of operations. The results of operations for the three months ended March 31, 2008 are not necessarily indicative of results to be expected for the full year.

The condensed consolidated financial statements of the Company are presented in United States (U.S.) dollars unless otherwise noted and have been prepared by management in accordance with accounting principles generally accepted in the United States of America (US GAAP). The preparation of financial statements in conformity with US 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates with regard to these financial statements include the estimate of proved natural gas and oil reserve quantities and the related present value of estimated future net cash flows.

The condensed consolidated financial statements include the accounts of the Company and the consolidated accounts of all its subsidiaries. The entities included in these consolidated accounts are all wholly owned. All significant intercompany accounts and transactions have been eliminated in consolidation.

Certain information provided for the prior period has been reclassified to conform to the presentation adopted in 2008.

New Accounting Pronouncements

Fair Value Measurements. In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 applies to other accounting pronouncements that require or permit fair value measurements; however, it does not require any new fair value measurements. The provisions of SFAS 157 are effective for the years beginning after November 15, 2007 and interim periods within those years. The FASB has also issued Staff Position FSP FAS No. 157-2 (FSP FAS No. 157-2), which delays the effective date of SFAS 157 for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008. Effective January 1, 2008, the Company adopted SFAS 157 and has chosen to defer the implementation of nonfinancial assets and liabilities in accordance with FSP FAS No. 157-2. The effect of adoption in January 1, 2008 was immaterial to the Company s financial position. The adoption of FSP FAS No. 157-2 is not expected to have a material impact on the Company s results of operations, cash flows or financial positions. See Note 10, Fair Value Measurements for additional information regarding the adoption of SFAS No. 157.

FASB Statement of Accounting Standard No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159)*: SFAS No. 159, issued in February 2007, allows entities the option to measure eligible financial instruments at fair value as of specified dates. Such election, which may be applied on an instrument by instrument basis, is typically irrevocable once elected. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007, and early application is allowed under certain circumstances. The Company adopted SFAS 159 on January 1, 2008, which allows an entity the

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GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. The Company did not elect fair value as an alternative, as provided under SFAS 159 for any of its financial assets and liabilities that are not currently measured at fair value.

Non-controlling Interests in Consolidated Financial Statements. In December 2007, the FASB Issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of Accounting Research Bulletin No. 51 (SFAS No. 160), which improves the relevance, comparability and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This statement is effective for fiscal years beginning after December 15, 2008. The Company does not expect the adoption of SFAS No. 160 to have a material impact on the Company s consolidated financial position, results of operations or cash flows.

Business Combinations. In December 2007, FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS No. 141R), which replaces SFAS No. 141 (SFAS No. 141). This statement retains the fundamental requirements in SFAS No. 141 that the acquisition method of accounting (which SFAS No. 141 called the *purchase* method) be used for all business combinations. SFAS No. 141R also establishes principles and requirements for how the acquirer: (a) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; (b) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and (c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141R is effective as of the beginning of an entity s fiscal year that begins after December 15, 2008. Early adoption is prohibited. The Company is currently evaluating the impact of adopting SFAS No. 141R, which also requires acquisition transaction costs to be expensed as incurred rather than capitalized as a direct cost of the acquisition, as transaction costs are not considered an element of the fair value of the company acquired. Depending upon the size, nature and complexity of a future acquisition transaction, such transaction costs could be material to the Company s results of operations.

2. Property, Plant and Equipment

The amount capitalized as natural gas and oil properties was incurred for the purchase and development of various properties in the states of California, Montana, Texas, West Virginia and Wyoming in the United States and in New South Wales and Victoria in Australia. The following schedule represents natural gas and oil property costs by country:

	United States	Australia (in thousands)	Total
From inception to March 31, 2008:			
Natural gas and oil properties, full cost method of accounting:			
Unproved properties	$ 59,562	$ 24,717	$ 84,279
Proved properties	248,886	604	249,490
Total natural gas and oil properties	308,448	25,321	333,769
Furniture and equipment	666	97	763
Total property and equipment	309,114	25,418	334,532
Impairment of proved natural gas and oil properties	(104,205)	(604)	(104,809)
Accumulated depreciation, depletion and amortization	(62,350)	(15)	(62,365)
Total accumulated depreciation, depletion and amortization	(166,555)	(619)	(167,174)

Total property and equipment, net	$ 142,559	$ 24,799	$ 167,358

At March 31, 2008, unproved properties not being amortized consisted of U.S. drilling in progress costs of $9.9 million, U.S. acreage acquisition costs of $49.7 million and Australian unevaluated property costs of $24.7 million.

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GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

There was no impairment of United States or Australian properties during the three months ended March 31, 2008 or 2007.

3. Long-Term-Debt

The following shows the Company s long-term debt as of the dates indicated:

	March 31, 2008	December 31, 2007
	(in thousands)	
Revolving credit facility	$	$
12 3/4% senior secured notes	99,524	99,506
Convertible senior debenture	30,000	30,000
Subordinated unsecured notes payable	3,191	3,179
Total net carrying value of long-term debt	132,715	132,685
Debt discount costs to be accreted	535	565
Total long-term debt at maturity	$ 133,250	$ 133,250

12 3/4% Senior Secured Notes due 2012

On November 29, 2007, Gastar Exploration USA, Inc. (Gastar USA), a wholly owned subsidiary of Gastar Exploration Ltd., (Parent) sold $100.0 million aggregate principal amount of 12 3/4% Senior Secured Notes due December 1, 2012 (12 3/4% Senior Secured Notes) at an issue price of 99.50%. Approximately $76.7 million of the $92.5 million net proceeds from the offering were used to repay the then outstanding senior secured notes, with the remaining net proceeds to be used for general corporate purposes. Interest is payable, semi-annually on June 1 and December 1, in cash on the principal amount at an annual rate of 12 3/4%. The annual effective interest rate, after amortization of the debt discount and fees paid to establish the 12 3/4% Senior Secured Notes, is 14.89%. The 12 3/4% Senior Secured Notes are fully and unconditionally guaranteed jointly and severally by Gastar USA, the Parent and all of the Parent s existing and future material domestic subsidiaries. The 12 3/4% Senior Secured Notes and the guarantees are secured by a lien on Gastar USA s principal domestic oil and gas properties and other assets that secure Gastar USA s revolving credit facility (Revolving Credit Facility), subject to certain exceptions. The 12 3/4% Senior Secured Notes mature on December 1, 2012.

As of March 31, 2008, the Company was in compliance with all debt covenants under the 12 3/4% Senior Secured Notes.

Revolving Credit Facility

On November 29, 2007, concurrent with the closing of the 12 3/4% Senior Secured Notes, Gastar USA entered into a revolving credit facility currently providing for a first priority lien maximum borrowing base of $19.4 million. At March 31, 2008, $2.5 million of the available borrowing base was utilized as collateral for a $2.5 million letter of credit to support the Company s hedging activities. The balance of the borrowing base, or $16.9 million, remained available to the Company. The borrowing base is to be redetermined at least semiannually, using the lender s usual and customary criteria for natural gas and oil reserve valuation. The applicable interest rate margin varies from -0.75% to 0.0% in the case of borrowings based on the prime rate and from 1.5% to 2.25% in the case of borrowings based on the Eurodollar rate, depending on the utilization level in relation to the borrowing base. At March 31, 2008, the prime rate and the Eurodollar rate were 5.25% and 2.7%, respectively. The Revolving Credit Facility is guaranteed by the Parent and all its current domestic subsidiaries and all future domestic subsidiaries formed during the term of the Revolving Credit Facility. Borrowings and related guarantees under the Revolving Credit Facility are secured by a first priority lien on all domestic natural gas and oil properties currently owned by or later acquired by Gastar USA, excluding de minimus value properties as determined by the lender. The revolving credit facility matures on October 15, 2009.

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

As of March 31, 2008, the Company was in compliance with all debt covenants under the revolving credit facility.

Convertible Senior Debentures

In November 2004, the Company issued $30.0 million aggregate principal amount of convertible senior unsecured debentures. The convertible senior debentures have a term of five years and will be due November 20, 2009 and bear interest at 9.75% per annum, payable quarterly. The convertible senior debentures are convertible by the holders into 6,849,315 common shares at a conversion price of $4.38 per share

Subordinated Unsecured Notes Payable

The Company s subordinated unsecured notes mature between April 2009 and September 2009, bear interest at 10% per annum and are callable by the Company at 105% after three years and 101% after four years.

4. Equity Compensation Plans

Share-Based Compensation Plans

2002 Stock Option Plan. The Company s 2002 Stock Option Plan was approved and ratified by the Company s shareholders in July 2002. It authorizes the Company s Board of Directors to issue stock options to directors, officers, employees and consultants of the Company and its subsidiaries to purchase a maximum of 25.0 million common shares. Stock option grant expirations vary between five and ten years. The vesting schedule has varied from two years to four years but generally has occurred over a four-year period at 25% per year beginning on the first anniversary date of the grant. Stock options issued pursuant to the Company s 2002 Stock Option Plan have an exercise price determined by the Board of Directors, but that exercise price cannot be less than the market price on the date immediately prior to the date of grant as reported by any stock exchange on which the Company s common shares are listed. If a stock option granted under the Company s 2002 Stock Option Plan expires or terminates for any reason in accordance with the terms of the Company s Stock Option Plan, the unpurchased common shares subject to that stock option become available for other stock option grants.

In April 2004, the Board of Directors amended the provisions of the Company s 2002 Stock Option Plan to specifically incorporate a provision to provide for stock options to be exercised on a cashless basis, whereby the Company issues to the optionee the number of common shares equal to the stock option exercised, less the number of common shares which when multiplied by the market price at the date of exercise equals the aggregate exercise price for all of the common shares exercised. As of March 31, 2008, stock option grants covering the issuance of 9,648,750 common shares were outstanding under the 2002 Stock Option Plan.

2006 Gastar Long-Term Stock Incentive Plan. On June 1, 2006, the Company s shareholders approved the 2006 Gastar Long-Term Stock Incentive Plan. The 2006 Gastar Long-Term Stock Incentive Plan authorizes the Company s Board of Directors to issue stock options, stock appreciation rights, bonus stock awards and any other type of award established by the Remuneration Committee which is consistent with the Plan s purposes to directors, officers and employees of the Company and its subsidiaries covering a maximum of 5.0 million common shares. The contractual life and vesting period for a grant is determined by the Board of Directors at the time the grant is awarded. The vesting period for restricted common stock grants during 2007 and 2008 was over four years, with one-third vesting on the second, third and fourth anniversaries of the date of grant. As of March 31, 2008, grants covering the issuance of 1,106,000 restricted common shares were outstanding under the 2006 Gastar Long-Term Stock Incentive Plan.

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GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Determining Fair Value under SFAS No. 123R

In determining fair value for stock option grants pursuant to SFAS No. 123R, the Company utilized the following assumptions:

Valuation and Amortization Method. The Company estimates the fair value of share-based awards granted using the Black-Scholes-Merton valuation model. The fair value of all awards is expensed using the graded-vesting method .

Expected Life. The expected life of awards granted represents the period of time that stock options are expected to be outstanding. Prior to 2008, the Company determined the expected life using the simplified method resulting in a 6.25-year expected life in accordance with Staff Accounting Bulletin No. 107 for all stock options issued with a four-year vesting period and a ten-year grant expiration. Using the simplified method, stock options that have been issued with two and three-year vesting periods and having a ten-year expiration have an expected life of 5.75 and 6.0 years, respectively. Beginning in 2008, management determined the expected life of stock option grants to be 6.25 years, based on historical records.

Expected Volatility. Using the Black-Scholes-Merton valuation model, the Company estimates the volatility of its common shares at the beginning of the quarter in which the stock option is granted. The volatility is based on historical movements of our common share price on the American Stock Exchange and the Toronto Stock Exchange over a period that approximates the expected life.

Risk-Free Interest Rate. The Company utilizes a risk-free interest rate equal to the rate of U.S. Treasury zero-coupon issues as of the date of grant with a term equivalent to the stock option s expected life.

Expected Dividend Yield. The Company has not paid any cash dividends on its common shares and does not anticipate paying any cash dividends in the foreseeable future. Consequently, a dividend yield of zero is utilized in the Black-Scholes-Merton valuation model.

Expected Forfeitures. Beginning March 1, 2008, the Company increased the forfeiture rate to 6% from 5% previously used. The forfeiture rate is used in calculating compensation expense and is based on the number of forfeitures of all unvested stock option since January 1, 2004 as a percentage of all stock option grants since January 1, 2004 calculated at the beginning of the year.

The fair value of each stock option grant is estimated on the date of grant using the Black-Scholes-Merton valuation pricing model. There were no stock options granted during the three months ended March 31, 2008. The table below summarizes the number of stock options granted and the assumptions for the stock options granted for the period indicated.

	For the Three Months Ended March 31, 2007
Stock options granted	227,000
Expected life (years)	6.25
Expected volatility	44.4%
Risk-free interest rate	4.6%-4.8%

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GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The weighted average grant date fair value of stock options granted and the intrinsic value of stock options exercised are shown below for the periods indicated. Intrinsic value of stock options is calculated using the difference between the common share price on the date of exercise and the exercise price times the number of stock options exercised. There were no stock options granted or exercised during the three months ended March 31, 2008.

	For the Three Months Ended March 31, 2007	
Weighted average fair value per share of stock options granted	$	1.08
Intrinsic value of stock options exercised	$	

Stock Option Activity

The following table summarizes the annual changes and option exercise prices for stock options under the Company s Stock Option Plan for the three months ended March 31, 2008:

	Number of Shares Under Stock Options	Weighted Average Exercise Price	
Stock options outstanding as of December 31, 2007	10,173,750	$	3.19
Stock options granted		$	
Stock options exercised		$	
Stock options cancelled/expired	525,000	$	4.27
Stock options outstanding as of March 31, 2008	9,648,750	$	3.14
Stock options exercisable:			
March 31, 2008	5,643,866	$	3.21

The table below summarizes certain information about the stock options for the three months ended March 31, 2008. Fair value calculations are as of the date of grant.

	Number of Shares Under Stock Options	Weighted Average Fair Value	
Unvested stock options at the beginning of the quarter	5,045,834	$	1.22
Unvested stock options at the end of the quarter	4,578,334	$	1.21
Stock options granted during the quarter		$	
Stock options vested during the quarter	117,500	$	1.68
Stock options forfeited/canceled during the quarter	525,000	$	1.09

As of March 31, 2008, there was no aggregate intrinsic value for outstanding stock options, and the remaining weighted average contractual life of outstanding stock options was 5.0 years. As of March 31, 2008, there was no aggregate intrinsic value for exercisable stock options, and the remaining weighted average contractual life of exercisable stock options was 3.5 years. As of March 31, 2008, the total fair value of exercisable stock options was $5.6 million.

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GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Restricted Share Activities

The following table summarizes the changes and grant date prices for restricted common share grants for the three months ended March 31, 2008:

	Number of Shares Under Stock Options	Weighted Average Grant Date Fair Value
Restricted common shares outstanding as of December 31, 2007	1,096,000	$ 2.15
Restricted common shares granted	10,000	$ 1.09
Restricted common shares vested		$
Restricted common shares cancelled/expired		$
Restricted common shares outstanding as of March 31, 2008	1,106,000	$ 2.14

The following table summarizes the range of grant dates (expiration dates) and grant date prices for restricted common shares outstanding and unvested as of March 31, 2008:

	Restricted Common Shares Outstanding	Grant Date Fair Value
July 3, 2007 (July 3, 2011)	983,500	$ 2.20
August 27, 2007 (August 27, 2011)	112,500	$ 1.67
January 16, 2008 (January 16, 2012)	10,000	$ 1.09
Total	1,106,000	$ 2.14

Stock-Based Compensation Expense

For the three months ended March 31, 2008 and 2007, the Company recorded stock-based compensation expense for stock options and restricted common shares granted using the fair-value method of $856,000 million and $1.2 million, respectively. All stock based compensation costs were expensed and not tax effected, as the Company currently records no income tax expense. All common shares issued upon exercise or vesting are reserved and non-assessable.

5. Commodity Hedging Contracts

The following costless collar transactions were outstanding with associated notional volumes and contracted floor and ceiling prices that represent hedge prices for the index specified as of March 31, 2008:

Date	Period	Derivative Instrument (1)	Hedge Strategy	Notional Daily Volume (MMBtu)	Total of Notional Volume (MMBtu)	Floor Price (MMBtu)	Ceiling Price (MMBtu)	Index	Production Area Hedged
09/21/07	Cal 08	CC	Cash flow	2,000	732,000	$ 5.50	$ 7.50	CIG (3)	WY
12/12/07	Cal 08	CC	Cash flow	5,000	1,830,000	$ 6.75	$ 8.00	HSC (2)	TX
01/03/08	02-12/08	CC	Cash flow	5,000	1,675,000	$ 7.00	$ 8.88	HSC (2)	TX
01/18/08	02-12/08	CC	Cash flow	800	268,000	$ 6.00	$ 7.90	CIG (3)	WY
02/19/08	Cal 09	CC	Cash flow	5,000	1,825,000	$ 8.00	$ 9.30	HSC (2)	TX

(1) Costless collars.
(2) East-Houston-Katy - Houston Ship Channel.
(3) Inside FERC Colorado Interstate Gas, Rocky Mountains.

As of March 31, 2008, the Company s current cash flow hedge positions were with counterparties that are major United States financial institutions. The credit support for certain of the Company s hedges is a $2.5 million letter of credit, with the remaining credit support under the Revolving Credit Facility through intercreditor agreements. Based on the Company s December 31, 2007 third party engineering report, the Company had approximately 50% of its 2008 estimated proved developed production hedged and 30% of its 2009 estimated proved developed production hedged.

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The Company recorded a short term and a long term derivative liability of $5.4 million and $545,000, respectively, related to the difference between hedged commodity prices and market prices on hedged volumes as of March 31, 2008, after application of FAS157 Fair Value Measurement. All of the Company s derivative instruments have been designated cash flow as hedging instruments and are deemed to be highly effective. The Company recognized unrealized losses in the statement of operations on the cash flow hedges due to ineffectiveness of $169,000 and $1.2 million related to the time value of the costless collars. The Company records time value on the costless collars designated as cash flow hedges currently in earnings, as it has elected to exclude time value from its assessment of hedge effectiveness.

6. Common Shares

Authorized

The Company s articles of incorporation allow the Company to issue an unlimited number of common shares without par value.

Other Share Issuances

During three months ended March 31, 2008, pursuant to the Company s 2006 Gastar Long-Term Stock Incentive Plan, the Company issued 10,000 restricted common shares to an employee, subject to vesting.

Shares Reserved

At March 31, 2008, the Company has reserved 16,730,586 common shares to be issued pursuant to the conversion of convertible debt (6,849,315 common shares), exercise of options (9,648,750 common shares) and the exercise of warrants (232,521 common shares).

7. Warrants

The following table summarizes warrant information to purchase common shares as of March 31, 2008:

	Number of Warrants	Fair Value of Warrants (in thousands)	Weighted Average Warrant Price	Weighted Average Remaining Life in Years	Weighted Average Exercise Price
Warrants issued in connection with $3.25 million subordinated unsecured notes payable	232,521	$ 235	$ 2.80	1.1	$ 2.80

8. Interest Expense

The following tables summarize the components of interest expense:

	For the Three Months Ended March 31. 2008	2007
	(in thousands)	
Interest expense:		

Cash and accrued	$ 4,004	$ 2,866
Amortization of deferred financing costs and debt discount	463	1,077
Capitalized interest	(2,371)	
Total interest expense	$ 2,096	$ 3,943

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9. Income Taxes

Due to the Company s significant net operating loss carryforwards, the Company did not record any income tax expense for the three months ended March 31, 2008 and 2007. The Company fully reserves its deferred tax asset through a valuation allowance.

10. Fair Value Measurements

Fair Value Measurements. In September 2006, the FASB issued SFAS 157, which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 applies to other accounting pronouncements that require or permit fair value measurements; however, it does not require any new fair value measurements.

SFAS 157 establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument.

Level 3 inputs are measured based on prices or valuation models that require inputs that are both significant to the fair value measurement and less observable from objective sources. The Company s valuation models consider various inputs including: (a) quoted forward prices for commodities, (b) time value, (c) volatility factors and (d) current market and contractual prices for the underlying instruments. Level 3 instruments are natural gas zero cost collars. Although the Company utilizes third party broker quotes to assess the reasonableness of prices and valuation techniques, the Company does not have sufficient corroborating market evidence to support classifying these assets and liabilities as Level 2.

A financial asset or liability s classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement. The determination of the fair values below incorporates various factors required under SFAS 157, including the impact of our nonperformance risk on our liabilities. The following table provides the assets and liabilities carried at fair value measured on a recurring basis as of March 31, 2008:

	As of March 31, 2008			
Recurring Fair Value Measures	**Level 1**	**Level 2**	**Level 3**	**Total**
			(in thousands)	
Assets:				
Derivative assets	$	$	$	$
Liabilities:				
Derivative liabilities	$	$	$ (5,967)	$ (5,967)

The following table sets forth a reconciliation of changes in the fair value of financial assets and liabilities classified as level 3 in the fair value hierarchy:

		Derivatives (in thousands)
Balance as of January 1, 2008	$	(391)
Total gains or losses (realized or unrealized)		
Included in earnings (1)		(1,413)
Included in other comprehensive loss		(4,395)
Purchases, issuances and settlements		232
Transfers in and out of Level 3		
Balance as of March 31, 2008	$	(5,967)
Changes in unrealized losses relating to derivatives still held as of March 31, 2008	$	(1,413)

(1) This amount is included in revenues on the statement of operations as unrealized gas hedge loss.

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11. Earnings or Loss per Share

In accordance with the provisions of Statement of Financial Standards No. 128 Earnings per Share , basic earnings or loss per share is computed on the basis of the weighted average number of common shares outstanding during the periods. Diluted earnings or loss per share is computed based upon the weighted average number of common shares plus the assumed issuance of common shares for all potentially dilutive securities. Diluted amounts are not included in the computation of diluted loss per share, as such would be anti-dilutive.

	For the Three Months Ended March 31, 2008	2007
	(in thousands, except per share and share data)	
Basic and diluted income (loss) and shares outstanding:		
Net income (loss)	$ 1,087	$ (10,955)
Weighted average common shares outstanding:		
Basic and diluted	207,098,570	195,015,561
Basic and diluted income (loss) per common share:		
Basic and diluted	$ 0.01	$ (0.06)
Common shares excluded from denominator as anti-dilutive:		
Stock options (1)	9,648,750	10,699,750
Unvested restricted common shares (2)	1,106,000	
Warrants (1)	232,521	2,732,521
Convertible senior debentures (1)	6,849,315	6,849,315
Total	17,836,586	20,281,586

(1) Common shares for the 2008 period have been excluded as the strike price of each was greater than the market price as of March 31, 2008.

(2) Unvested common shares are included in the total outstanding number of common shares but are excluded from the calculation of weighted average common shares when calculating income per share.

12. Commitments and Contingencies

Litigation

The Company is party to various litigation matters. The ultimate outcome of the matters discussed below cannot presently be determined, nor can the liability that could potentially result from an adverse outcome be reasonably estimated at this time. The more significant litigation matters are summarized below.

Arbitration against GeoStar Corporation and Affiliates. On October 18, 2006, in connection with 10 wells to be drilled in Victoria, Australia on the jointly owned EL 4416 exploration license operated by GeoStar Corporation, the Company sent a letter to GeoStar demanding the arbitration of certain disputed issues and interpretations under a Participation and Operating Agreement (POA) with GeoStar and its subsidiaries. Among other items, the claims the Company presented for resolution in arbitration include claims relating to GeoStar s demands for cash calls under the POA while simultaneously asserting that certain provisions of the POA, including overhead reimbursement rates, need to be renegotiated on terms that the Company believes are not reasonable or within industry standards. The Company has also requested that GeoStar s Australian subsidiary provide a record title assignment of the Company s beneficial interests in EL 4416, the exploration license in the Gippsland Basin property in Victoria, Australia. The Company has approximately $9.9 million invested in EL 4416 as of March 31, 2008. GeoStar contends that the Company is not entitled to the record title assignment notwithstanding the Company s significant investment. The Company s former Chairman of the Board is a major shareholder and President of GeoStar. GeoStar has voluntarily dismissed its efforts to enjoin the arbitration from

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

proceeding and has answered and asserted counterclaims. Those counterclaims include (a) a request for a declaration that the Company has no rights to participate in brown coal projects in EL 4416, (b) a request for a declaration that the Company did not earn an interest under the POA as to certain wells the Company drilled in East Texas, (c) breach of contract for failure to pay certain bills and expenses and (d) breach of contract to pay for employee expenses and services. The Company, which denies and intends to vigorously defend each of these counterclaims, contends that it has participation rights to the full scope of EL 4416 under the terms of the POA and that the Texas wells were drilled on lands to which the Company obtained rights under separate 2005 Purchase and Sale Agreements. The three-member arbitration panel has been appointed. The date of the arbitration has been postponed and a new date has not been determined.

Gastar Exploration, Ltd., Gastar Exploration Texas, Inc., f/k/a First Texas Development, Inc., Gastar Exploration Texas LLC, f/k/a Bossier Basin, LLC, and Gastar Exploration Texas LP, f/k/a First Source Gas, LP v. GeoStar Corporation, First Source Texas, Inc., First Source Bossier, LLC, and First Texas Gas, LP. In July 2007, the Company filed a lawsuit in Robertson County, Texas against GeoStar and affiliates seeking relief in connection with the failure by GeoStar and its affiliates to execute formal assignments of certain leases that were omitted from the schedule of leases attached to the assignments executed by GeoStar affiliates in June 2005 pursuant to Purchase and Sale Agreements covering Texas properties of GeoStar and its affiliates. The lawsuit asks the court to decree that in the transaction evidenced by the Purchase and Sale Agreements, affiliates of the Company acquired title to all properties in Texas in which GeoStar and its affiliates owned an interest and that GeoStar and its affiliates are obligated to execute formal assignments with regard to all such leases. GeoStar and one of its affiliates have filed a challenge to the Texas court s jurisdiction. Additionally, GeoStar and certain of its affiliates have also filed counterclaims in this litigation, which are described below and in the section below entitled GeoStar Look Back Developments .

Gastar Exploration Ltd., Gastar Exploration USA, Inc. f/k/a First Sourcenergy Wyoming Inc., Gastar Exploration New South Wales, Inc., f/k/a First Sourcenergy Group, Inc., Gastar Exploration Victoria, Inc. f/k/a First Sourcenergy Victoria, Inc.,, Gastar Exploration Texas, Inc., f/k/a First Texas Development, Inc., Gastar Exploration Texas LLC, f/k/a Bossier Basin, LLC, and Gastar Exploration Texas LP, f/k/a First Source Gas, LP v. GeoStar Corporation. In July 2007, the Company and affiliates filed a lawsuit in the District Court of Harris County, Texas against GeoStar in connection with GeoStar s failure to deliver to the Company and its affiliates the corporate records of the Company and to its affiliates that have been retained by GeoStar. Representatives of the Company and its affiliates previously demanded return of the corporate records retained by GeoStar, but GeoStar failed to return the records. The lawsuit asks the court to decree that the Company and its affiliates are entitled to possession of the corporate records and order their return to the Company and its affiliates. The lawsuit also seeks recovery of actual and punitive damages, costs, and attorney s fees. GeoStar has now delivered some of the requested records that are the subject of this litigation to the Company, and the Company has requested that GeoStar deliver additional records. Additionally, GeoStar and certain of its affiliates have also filed counterclaims in this litigation, which are described below and in the section below entitled GeoStar Look Back Developments .

Gastar Exploration, Ltd., Gastar Exploration Texas, Inc., f/k/a First Texas Development, Inc., Gastar Exploration Texas LLC, f/k/a Bossier Basin, LLC, and Gastar Exploration Texas LP, f/k/a First Source Gas, LP v. GeoStar Corporation, First Source Texas, Inc., First Source Bossier, LLC, and First Texas Gas, LP. In August 2007, the Company and certain affiliates filed a second lawsuit in Robertson County, Texas, seeking a declaratory judgment that the Company and its affiliates have complied with the Look-Back provisions of the Texas Purchase and Sale Agreements that are the subject of the other Robertson County, Texas lawsuit referenced above, that the Company and its affiliates have complied with the provisions of the Texas Purchase and Sale Agreements relating to the drilling of wells, and that GeoStar and its affiliates hold no farm-in interest in properties owned by the Company s affiliates. GeoStar and one of its affiliates have filed a challenge to the Texas court s jurisdiction. The defendants also have generally denied the allegations made in the lawsuit. Additionally, GeoStar and certain of its affiliates have also filed counterclaims in this litigation, which are described in the following paragraph and in the section below entitled GeoStar Look Back Developments .

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Although it previously contested jurisdiction in Texas, GeoStar (together with certain of its affiliates) has as of January and February 2008 asserted counterclaims in all three Texas lawsuits similar to claims GeoStar had previously asserted and dismissed in the Michigan lawsuit described below. The counterclaims relate to Texas properties that were the subject of Purchase and Sale Agreements entered into in 2005, under which the Company acquired the interests of GeoStar-affiliated entities in properties in Texas. Specifically, GeoStar claims that the Company breached the Purchase and Sale Agreements by failing to provide information in connection with contingent Look Back payments under provisions of the Purchase and Sale Agreements, and by failing to make payments allegedly due to GeoStar under the Look-Back provisions, arising out of alleged changes in reserves following the sale of the Texas properties in June 2005. Although requesting only damages in an unspecified amount, GeoStar contends in the counterclaim that it would have been entitled under the Purchase and Sale Agreements to approximately 1.7 billion shares of Gastar stock. GeoStar also claims that the Company failed to timely comply with provisions of the Purchase and Sale Agreements relating to the drilling of 20 wells on the properties conveyed under the Purchase and Sale Agreements and by failing to drill and test at least two wells in the Travis Peak formation in Texas, allegedly entitling GeoStar to unspecified damages related to a farm-in interest under which it was allegedly entitled to the right to drill, complete, and operate wells in the Travis Peak formation on certain acreage. The Company intends to vigorously defend the counterclaims. The Company has moved to abate the Harris County proceedings with respect the counterclaims in favor of the earlier-filed Robertson County proceedings. Certain information that may be relevant to this matter is set forth below in the section below entitled GeoStar Look Back Developments .

GeoStar Corporation and West Virginia Gas Corporation v. Gastar Exploration Ltd. and J. Russell Porter. On July 27, 2007, the Company was served with a lawsuit filed by GeoStar and one of its affiliates, West Virginia Gas Corporation, in federal court in Saginaw, Michigan. GeoStar asserted a broad range of claims against the Company and its current chief executive officer, J. Russell Porter.

GeoStar initially sought in the Michigan suit to enjoin the Company s arbitration against GeoStar and its affiliates. GeoStar has now voluntarily dismissed that request with prejudice.

GeoStar also claims in the Michigan suit that the POA was cancelled effective January 1, 2005, and that the parties have operated under oral contracts since that date. GeoStar asserts that the Company has breached the alleged oral contracts by allegedly failing to pay joint interest billings, authorizations for expenditures, and cash calls relating to operations or proposed operations on EL 4416 in Australia and West Virginia properties, in an unspecified amount exceeding $75,000. GeoStar also claims that the Company has breached alleged agreements to reimburse GeoStar for various payments and services allegedly performed by GeoStar and its personnel and paid on behalf of the Company by GeoStar. GeoStar claims that the amounts of the payments and the value of the services exceed $10.0 million. GeoStar alternatively alleges that if there was no contract covering those payments and services, it allegedly is entitled to reimbursement on equitable principles. On January 15, 2008, the federal court granted the Company s motion to dismiss these claims for failure to state a claim on which reli