GASTAR EXPLORATION LTD
Form 10-Q
August 11, 2008
Table of Contents

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 JUNE 30, 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	**98-0570897**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

1331 Lamar Street, Suite 1080

Houston, Texas 77010	**77010**
(Address of principal executive offices)	**(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 the definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

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

Total number of common shares, no par value per share, as of August 8, 2008 was 209,894,913.

Table of Contents

GASTAR EXPLORATION LTD.

QUARTERLY REPORT ON FORM 10-Q

FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2008

TABLE OF CONTENTS

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 dollars and (iii) all financial data included in this Form 10-Q have 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 Form 10-Q. Our Annual Report 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 our United States filings and on SEDAR at www.sedar.com for our Canadian filings.

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS

	June 30, 2008 (Unaudited)	December 31, 2007
	(in thousands)	
CURRENT ASSETS:		
Cash and cash equivalents	$ 42,016	$ 85,854
Accounts receivable, net of allowance for doubtful accounts of $606 and $4,245, respectively	8,578	4,828
Due from related parties	1,873	904
Prepaid expenses	432	1,235
Total current assets	52,899	92,821
PROPERTY, PLANT AND EQUIPMENT:		
Natural gas and oil properties, full cost method of accounting:		
Unproved properties, not being amortized	110,767	69,844
Proved properties	278,093	247,372
Total natural gas and oil properties	388,860	317,216
Furniture and equipment	800	669
Total property, plant and equipment	389,660	317,885
Accumulated depreciation, depletion and amortization	(173,064)	(160,765)
Total property, plant and equipment, net	216,596	157,120
OTHER ASSETS:		
Restricted cash	71	1,074
Deferred charges, net	7,682	8,334
Drilling advances	2,009	2,251
Other assets	200	150
Total other assets	9,962	11,809
TOTAL ASSETS	$ 279,457	$ 261,750

LIABILITIES AND SHAREHOLDERS EQUITY

	June 30, 2008	December 31, 2007
CURRENT LIABILITIES:		
Accounts payable	$ 11,005	$ 12,001
Revenue payable	8,103	6,770
Accrued interest	1,463	1,534
Accrued drilling and operating costs	5,578	2,810
Commodity derivative contracts	11,883	480
Other accrued liabilities	5,497	4,831
Due to related parties	3,800	979
Current portion of long-term debt	2,907	
Total current liabilities	50,236	29,405
LONG-TERM LIABILITIES:		

Long-term debt, less current maturities	129,839	132,685
Asset retirement obligation	4,802	4,391
Commodity derivative contracts	2,620	
Total long-term liabilities	137,261	137,076
COMMITMENTS AND CONTINGENCIES (Note 13)		
SHAREHOLDERS EQUITY:		
Common stock, no par value, unlimited shares authorized, 209,894,913 and 208,194,570 common shares issued and outstanding at June 30, 2008 and December 31, 2007, respectively	249,980	249,980
Additional paid-in capital	21,465	14,366
Accumulated other comprehensive loss fair value of commodity hedging	(12,578)	(480)
Accumulated other comprehensive loss foreign exchange	28	(29)
Accumulated deficit	(166,935)	(168,568)
Total shareholders equity	91,960	95,269
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 279,457	$ 261,750

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

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2008	2007	2008	2007
	(in thousands, except shares and per share data)			
REVENUES:				
Natural gas and oil revenues	$ 15,884	$ 7,956	$ 32,730	$ 15,471
Unrealized natural gas hedge loss	(513)		(1,926)	
Total revenues	15,371	7,956	30,804	15,471
EXPENSES:				
Production taxes	474	220	743	514
Lease operating expenses	2,408	1,514	3,950	3,209
Transportation and treating	498	339	957	662
Depreciation, depletion and amortization	5,890	5,443	12,299	9,784
Impairment of natural gas and oil properties		28,514		28,514
Accretion of asset retirement obligation	82	72	164	138
Mineral resource properties		(136)		(123)
General and administrative expenses	4,064	3,519	8,339	10,311
Litigation settlement expense				1,365
Total expenses	13,416	39,485	26,452	54,374
INCOME (LOSS) FROM OPERATIONS	1,955	(31,529)	4,352	(38,903)
OTHER (EXPENSES) INCOME:				
Interest expense	(1,889)	(3,738)	(3,985)	(7,681)
Investment income and other	481	772	1,304	1,135
Gain on sale of unproved natural gas and oil properties		38,872		38,872
Foreign transaction loss	(1)	3	(38)	2
INCOME (LOSS) BEFORE INCOME TAXES	546	4,380	1,633	(6,575)
Provision for income taxes				
NET INCOME (LOSS)	$ 546	$ 4,380	$ 1,633	$ (6,575)
NET INCOME (LOSS) PER SHARE:				
Basic	$ 0.00	$ 0.02	$ 0.01	$ (0.03)
Diluted	$ 0.00	$ 0.02	$ 0.01	$ (0.03)
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:				
Basic	207,098,570	201,918,634	207,098,570	198,488,244
Diluted	207,475,168	201,918,634	207,475,168	198,488,244

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

2

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the Six Months Ended June 30, 2008	2007
	(in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 1,633	$ (6,575)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation, depletion and amortization	12,299	9,784
Impairment of natural gas and oil properties		28,514
Stock based compensation	1,711	2,167
Unrealized natural gas hedge loss	1,926	
Amortization of deferred financing costs and debt discount	948	2,167
Accretion of asset retirement obligation	164	138
Gain on sale of unproved natural gas and oil properties		(38,872)
Changes in operating assets and liabilities:		
Restricted cash for hedging program	1,000	
Accounts receivable	(4,719)	6,920
Prepaid expenses	225	457
Accounts payable and accrued liabilities	9,071	971
Net cash provided by operating activities	24,258	5,671
CASH FLOWS FROM INVESTING ACTIVITIES:		
Development and purchases of natural gas and oil properties	(66,190)	(43,778)
Drilling advances	(1,551)	(147)
Proceeds from sale of unproved natural gas and oil properties, net of transaction costs		66,849
Purchase of furniture and equipment	(131)	(15)
Other	(50)	2
Net cash (used in) provided by investing activities	(67,922)	22,911
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common shares, net of share issue costs		23,381
Decrease in restricted cash	3	
Deferred financing charges and other	(177)	
Net cash provided by (used in) financing activities	(174)	23,381
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(43,838)	51,963
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	85,854	40,733
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 42,016	$ 92,696

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

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(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 and six months ended June 30, 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 dollars unless otherwise noted and have been prepared by management in accordance with 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

Disclosures about Derivative Instruments and Hedging Activities. In March 2008, the Financial Accounting Standards Board (FASB) issued Statements of Financial Accounting Standards (SFAS) SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS No. 161). SFAS No. 161 does not change accounting policy for derivatives but requires enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related hedged items (if any) are accounted for, and how they affect the Company s financial position, financial performance and cash flows. SFAS No. 161 is effective for annual and interim periods beginning with the first quarter of 2009. The Company is evaluating the provisions of SFAS No. 161.

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, Business Combinations (SFAS No. 141). SFAS 141R 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

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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.

Accounting Standard Fair Value for Financial Assets and Financial Liabilities. In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). SFAS No. 159 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 No. 159 on January 1, 2008, which allows an entity the 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 No. 159 for any of its financial assets and liabilities that are not currently measured at fair value.

Fair Value Measurements. In September 2006, the FASB issued SFAS 157, Fair Value Measurements (SFAS No. 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS No. 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 No. 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 No. 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 No. 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 for additional information regarding the adoption of SFAS No. 157.

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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, Pennsylvania and Wyoming in the United States and in New South Wales in Australia. The following schedule represents natural gas and oil property costs by country:

	United States	Australia (in thousands)	Total
From inception to June 30, 2008:			
Natural gas and oil properties, full cost method of accounting:			
Unproved properties	$ 93,440	$ 17,327	$ 110,767
Proved properties	277,489	604	278,093
Total natural gas and oil properties	370,929	17,931	388,860
Furniture and equipment	682	118	800
Total property and equipment	371,611	18,049	389,660
Impairment of proved natural gas and oil properties	(104,205)	(604)	(104,809)
Accumulated depreciation, depletion and amortization	(68,240)	(15)	(68,255)
Total accumulated depreciation, depletion and amortization	(172,445)	(619)	(173,064)
Total property and equipment, net	$ 199,166	$ 17,430	$ 216,596

At June 30, 2008, unproved properties not being amortized consisted of United States drilling in progress costs of $2.5 million, United States acreage acquisition costs of $91.0 million and Australian unevaluated property costs of $17.3 million.

There was no impairment of United States or Australian properties during the six months ended June 30, 2008. For the six months ended June 30, 2007, the results of management s ceiling test evaluation resulted in an impairment of United States proved properties of $28.5 million. Management determined that no impairment was required on Australian properties during six months ended June 30, 2007.

3. Long-Term-Debt

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

	June 30, 2008	December 31, 2007
	(in thousands)	
Revolving credit facility	$	$
12 $^{3}/4$% senior secured notes	99,543	99,506
Convertible senior debentures	30,000	30,000

Subordinated unsecured notes payable	296	3,179
Long-term portion of long-term debt	129,839	132,685
Current portion of long-term debt	2,907	
Total long-term debt	132,746	132,685
Debt discount costs to be accreted	504	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

6

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

purposes. Interest is payable semi-annually in arrears 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 14.85%. 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 natural gas and oil 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 June 30, 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 providing for a first priority lien borrowing base. The borrowing base is to be redetermined at least semi-annually, using the lender s usual and customary criteria for natural gas and oil reserve valuation. The administrative agent to the Company s Revolving Credit Facility has recently approved, subject to the agreement of the other syndication banks, to increase our borrowing base to $45.0 million, of which $6.5 million is being utilized as collateral for a letter of credit to support the Company s hedging activities. 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 June 30, 2008, the prime rate and the Eurodollar rate were 5.0% and 2.5%, 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.

As of June 30, 2008, the Company was in compliance with all debt covenants under the Revolving Credit Facility.

Convertible Senior Unsecured Debentures

In November 2004, the Company issued $30.0 million aggregate principal amount of convertible senior unsecured debentures. The convertible senior unsecured debentures have a term of five years and are due November 20, 2009 and bear interest at 9.75% per annum, payable quarterly. The convertible senior unsecured 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 101%. As of June 30, 2008, $2.9 million of the subordinated unsecured notes was reflected as current portion of long-term debt.

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 10 years.

7

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 2002 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 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 June 30, 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 June 30, 2008, grants covering the issuance of 2,796,343 restricted common shares were outstanding under the 2006 Gastar Long-Term Stock Incentive Plan.

Determining Fair Value under SFAS No. 123R

In determining fair value for stock option grants pursuant to SFAS 123R, Share-Based Payments (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.

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Risk-Free Interest Rate. The Company utilizes a risk-free interest rate equal to the rate of United States 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%. 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 six months ended June 30, 2008. The table below summarizes the number of stock options granted and the assumptions for the stock options granted for the six months ended June 30, 2007.

	For the Six Months Ended June 30, 2007
Stock options granted	227,000
Expected life (years)	6.25
Expected volatility	44.4%
Risk-free interest rate	4.6%-4.8%

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 six months ended June 30, 2008. The table below sets forth the weighted average fair value per share of stock options granted and the intrinsic value of stock options exercised during the six months ended June 30, 2007.

	For the Six Months Ended June 30, 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 2002 Stock Option Plan for the six months ended June 30, 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	$	2.48
Stock options outstanding as of June 30, 2008	9,648,750	$	3.16
Stock options exercisable:			
June 30, 2008	5,528,916	$	3.32

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The table below summarizes certain information about the stock options for the six months ended June 30, 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 December 31, 2007	5,045,834	$ 1.22
Unvested stock options at June 30, 2008	4,119,834	$ 1.19
Stock options granted during the six-month period		$
Stock options vested during the six-month period	576,000	$ 1.44
Stock options forfeited/canceled during the six-month period	525,000	$ 1.09

As of June 30, 2008, the aggregate intrinsic value for outstanding stock options was $964,000, and the remaining weighted average contractual life of outstanding stock options was 4.7 years. As of June 30, 2008, the aggregate intrinsic value for exercisable stock options was $314,000, and the remaining weighted average contractual life of exercisable stock options was 3.5 years. As of June 30, 2008, the total fair value of exercisable stock options was $6.3 million.

Restricted Share Activities

The following table summarizes the changes and grant date prices for restricted common share grants for the six months ended June 30, 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	1,700,343	$ 1.91
Restricted common shares vested		$
Restricted common shares cancelled/expired		$
Restricted common shares outstanding as of June 30, 2008	2,796,343	$ 2.00

For the six months ended June 30, 2008, the Company used the same 6% forfeiture rate for restricted common share grants, the same percentage used for stock option grants.

The following table summarizes the range of grant dates (final vesting dates) and grant date prices for restricted common shares outstanding and unvested as of June 30, 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
May 16, 2008 (May 16, 2012)	1,690,343	$	1.91
Total	2,796,343	$	2.00

Stock-Based Compensation Expense

For the six months ended June 30, 2008 and 2007, the Company recorded stock-based compensation expense for stock options and restricted common shares granted using the fair-value method of $1.7 million and $2.2 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.

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 June 30, 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	368,000	$ 5.50	$ 7.50	CIG (3)	WY
12/12/07	Cal 08	CC	Cash flow	5,000	920,000	$ 6.75	$ 8.00	HSC (2)	TX
01/03/08	Cal 08	CC	Cash flow	5,000	920,000	$ 7.00	$ 8.88	HSC (2)	TX
01/18/08	Cal 08	CC	Cash flow	800	147,200	$ 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
04/24/08	Cal 09	CC	Cash flow	5,000	1,825,000	$ 9.00	$ 11.85	HSC (2)	TX

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

As of June 30, 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 $6.5 million letter of credit, with the remaining credit support under the Revolving Credit Facility through intercreditor agreements. Based on the Company s third party engineering report, the Company had approximately 50% of its remaining 2008 estimated natural gas production hedged and 24% of its 2009 estimated natural gas production hedged as of June 30, 2008.

The Company recorded a short-term and a long-term derivative liability of $11.9 million and $2.6 million, respectively, related to the difference between hedged commodity prices and market prices on hedged volumes as of June 30, 2008, after application of SFAS No. 157. All of the Company s derivative instruments have been designated as cash flow hedging instruments and are deemed to be highly effective. The Company recognized unrealized losses in the statement of operations for the six months ended June 30, 2008 of $1.9 million related to the time value of the costless collars and did not recognize any ineffectiveness on the cash flow hedges. 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 the six months ended June 30, 2008, the Company issued 1,700,343 restricted common shares to employees, subject to vesting, pursuant to the Company s 2006 Gastar Long-Term Stock Incentive Plan.

Shares Reserved

At June 30, 2008, the Company has reserved 26,730,586 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 (10,232,521 common shares).

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

7. Warrants

The following table summarizes warrant information to purchase common shares as of June 30, 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	0.8	$ 2.80
Warrant issued in connection with the GeoStar litigation settlement	10,000,000	5,388	(1)	3.4	(1)

(1) The warrant is exercisable for $2.75 per share in the event that on or before June 11, 2011, the Company sells all or substantially all of its present oil and gas interests located in Leon and Robertson Counties in East Texas for net proceeds exceeding $500 million. A sale, or a series of sales, of all or substantially all of the Company s present East Texas properties prior to June 11, 2011 for $500 million or less will terminate the warrant. If the Company does not sell all or substantially all of these properties by June 11, 2011, the warrant will be exercisable for a six-month period commencing on that date at $3.00 per share. The Company is not obligated to sell any of its East Texas properties and is not currently pursuing any sale of its East Texas assets.

8. Interest Expense

The following tables summarize the components of interest expense:

	For the Three Months Ended June 30, 2008	For the Three Months Ended June 30, 2007	For the Six Months Ended June 30, 2008	For the Six Months Ended June 30, 2007
	(in thousands)			
Interest expense:				
Cash and accrued	$ 3,994	$ 2,647	$ 7,998	$ 5,514
Amortization of deferred financing costs and debt discount	485	1,091	948	2,167
Capitalized interest	(2,590)		(4,961)	
Total interest expense	$ 1,889	$ 3,738	$ 3,985	$ 7,681

9. Income Taxes

Due to the Company s significant net operating loss carryforwards, the Company did not record any income tax expense for the six months ended June 30, 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 No. 157, which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements; however, it does not require any new fair value measurements.

SFAS No. 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

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 s 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 No. 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 June 30, 2008:

	As of June 30, 2008			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Asset:				
Derivative asset	$	$	$	$
Liabilities:				
Derivative liability	$	$	$ (14,503)	$ (14,503)

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 for the three and six months ended June 30, 2008:

	Derivatives Three Months Ended June 30, 2008	Derivatives Six Months Ended June 30, 2008
	(in thousands)	
Balance as of March 31, 2008	$ (5,967)	$ (391)
Total gains or losses (realized or unrealized):		
Included in earnings (1)	(3,391)	(4,804)
Included in other comprehensive loss	(7,792)	(12,187)
Purchases, issuances and settlements	2,647	2,879
Transfers in and out of Level 3		
Balance as of June 30, 2008	$ (14,503)	$ 14,503
Changes in unrealized losses relating to derivatives still held as of June 30, 2008	$ (513)	$ (1,926)

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

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 June 30,		For the Six Months Ended June 30,	
	2008	2007	2008	2007
	(in thousands, except per share and share data)			
Basic and diluted income (loss) and shares outstanding:				
Net income (loss)	$ 546	$ 4,380	$ 1,633	$ (6,575)
Weighted average common shares outstanding:				
Basic	207,098,570	201,918,634	207,098,570	198,488,244
Diluted	207,475,168	201,918,634	207,475,168	198,488,244
Basic and diluted income (loss) per common share:				
Basic	0.00	0.02	0.01	(0.03)
Diluted	0.00	0.02	0.01	(0.03)
Common shares excluded from denominator as anti-dilutive:				
Stock options (1)	9,272,152	10,197,750	9,272,152	10,197,750
Unvested restricted common shares (2)	2,796,343		2,796,343	
Warrants issued in connection with $3.25 million subordinated unsecured notes payable (1)	232,521	2,732,521	232,521	2,732,521
Warrant issued in connection with the GeoStar litigation settlement (3)	10,000,000		10,000,000	
Convertible senior debentures (1)	6,849,315	6,849,315	6,849,315	6,849,315
Total	29,150,331	19,779,586	29,150,331	19,779,586

(1) Common shares for the 2008 periods have been excluded as the strike price of each was greater than the market price as of June 30, 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.
(3) Underlying common shares are excluded, as events required for exercise are conditional.

12. GeoStar Settlement

On June 11, 2008, the Company entered into a settlement agreement with GeoStar Corporation (GeoStar) to settle the look-back dispute and all other related outstanding disputes. The settlement included an upfront cash payment by the Company of approximately $25.7 million, plus the issuance to GeoStar of a warrant to purchase 10.0 million of the Company s common shares (the Warrant). Pursuant to the settlement, GeoStar assigned to the Company all of GeoStar s natural gas and oil interests in West Virginia, while the Company acknowledged GeoStar s clear title to an exploration license (EL 4416) and assigned to GeoStar its interest in an exploration license application (EL 4968), both located in Victoria, Australia. As of the settlement date, EL 4416 and EL 4968 had no attributable proved reserves or production. In addition, the Company released its claim to GeoStar on approximately 340 acres in East Texas that were in dispute. Certain other corrective lease assignments and releases are being made between the Company and GeoStar. The Company and GeoStar have mutually agreed to release all claims against each other, their affiliates and current and past officers and directors.

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

As part of the settlement, GeoStar has the right to farm-in from the Company two Hilltop well locations in East Texas and received an additional cash payment of approximately $3.2 million. The designated farm-in area is not included in the Company s future Bossier or Knowles drilling plans and does not include any proven or probable reserves.

The Warrant is exercisable for $2.75 per share in the event that on or before June 11, 2011, the Company sells up to all or substantially all of its present natural gas and oil interests located in Leon and Robertson Counties in East Texas for net proceeds exceeding $500 million. A sale, or a series of sales, of all or substantially all of the Company s present East Texas properties prior to June 11, 2011 for $500 million or less will terminate the Warrant. If the Company does not sell all or substantially all of these properties by June 11, 2011, the Warrant will be exercisable for a six-month period commencing on that date at $3.00 per share. The Company is not obligated to sell any of its East Texas properties and is not currently pursuing any sale of its East Texas assets.

As a result of the settlement with GeoStar, the Company had, net of the fair market value of Australian properties conveyed and the West Virginia properties received, a net increase in natural gas and oil properties of $31.5 million as of June 30, 2008. Major components of this increase in natural gas and oil properties are as follows:

	Amount (in thousands)
Cash payment	$ 25,741
Value of warrant issued to GeoStar	5,388
Net forgiveness of GeoStar receivables, payables, related accruals and other	(2,912)
Future cash payment obligation	3,256
Net increase in natural gas and oil properties related to settlement	31,473
Fair market value of properties conveyed (received):	
Australia EL 4416	9,015
West Virginia	(882)
Gross settlement value	$ 39,606

13. 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 Company does not expect that the outcome of the following will have a material adverse effect on its financial position, results of operations or cash flow.

Navasota Resources L.P. (Navasota) vs. First Source Texas, Inc., First Source Gas L.P. (now Gastar Exploration Texas LP) and Gastar Exploration Ltd. (Cause No. 0-05-451) District Court of Leon County, Texas 12th Judicial District. This lawsuit, dated October 31, 2005, contends that the Company breached Navasota s preferential right to purchase 33.33% of the Company s interest in certain natural gas and oil leases located in Leon and Robertson Counties and sold to Chesapeake Energy Corporation pursuant to a transaction closed November 4, 2005. The preferential right claimed is under an operating agreement dated July 7, 2000. The Company contends, among other things, that Navasota neither properly nor timely exercised any preferential right election it may have had with respect to the inter-dependent Chesapeake transaction. In July 2006, the District Court of Leon County, Texas issued a summary judgment in favor of the Company and Chesapeake. Navasota filed a Notice of Appeal to the Tenth Court of Appeals in Waco. Oral argument was heard on September 26, 2007 and the Court of Appeals issued its opinion on January 9, 2008 reversing the trial court s rulings and rendering judgment in favor of Navasota on all counts. The Company and Chesapeake filed a motion for rehearing on February 6, 2008, which was denied on March 18, 2008. The Company and Chesapeake filed a joint Petition for Review in the Texas Supreme Court on May 13, 2008, and the Texas Supreme Court requested a Response from Navasota,

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

which was filed on July 16, 2008. The Company and Chesapeake filed a Reply to Navasota s Response on July 31, 2008 and is awaiting a determination from the Texas Supreme Court on whether the Court will request full briefing on the merits. Pursuant to an agreement between the Company and Chesapeake, any adverse result in this matter should impact only Chesapeake s assigned leasehold interests. While this matter is pending, it is possible that expenditures incurred, or authorizations for proposed expenditures, for drilling activities on leases which include the disputed interest may remain unpaid or not be authorized by the non-operators asserting competing ownership rights, which could require the Company to either fund a disproportionate amount of drilling costs at its own risk or postpone its drilling program on affected leases.

Gastar Exploration Texas LP v. John E. McFarlane, et al (Cause No. 0-06-161) 87th Judicial District Court of Leon County, Texas. This suit is to quiet title to an undivided 25% mineral interest under an oil and gas lease dated December 4, 2003, covering approximately 2,598 gross acres (the Lease). John E. McFarlane and certain other family members contend that an undivided 25% mineral interest in the lands covered by the Lease are owned in trust by the grandchildren of Fay W. McFarlane and are not covered by the Lease as Gastar claims. McFarlane, *et. al*., filed an answer to the Company s petition and also filed several different motions for summary judgment which were denied by the District Court. A day long mediation of this lawsuit occurred on August 24, 2007, but the parties were unable to settle this matter at that time. The lawsuit is in the discovery phase and is currently set for a non-jury trial on December 2, 2008. The existence of unleased mineral interests in this Lease could adversely impact the future development of the Lease. The Company will continue to vigorously pursue this claim.

Spencer D. Plummer, III v. GeoStar Corporation, Classic Star LLC, Gastar Exploration, Ltd., Thom Robinson, Tony Ferguson, and John W. Parrott; In the United States District Court of Utah, Central Division (Case No. 2:07-CV-00409). This lawsuit was filed on May 24, 2007 initially in Utah state court by Spencer Plummer, or the Plaintiff, in which he asserts breaches of his Employment Agreement and subsequent Termination Agreement (the Agreements) with his employer, Classic Star, a subsidiary of GeoStar. The Plaintiff claims that he has not received benefits promised under such Agreements, including 699,249 shares of Company stock. The Company is not a party to the Agreements on which Plaintiff s claims are expressly based; however, the Company and Plaintiff are parties to a Stock Option Agreement on which Plaintiff claim to Company stock is partially based. The Company filed an Answer and Motion to Dismiss for lack of personal jurisdiction in Utah and for Plaintiff s failure to state a claim upon which relief can be granted. On August 1, 2008, the Kentucky court s granted the Company s Motion to Dismiss.

Craig S. Tillotson v. S. David Plummer 2nd, Spencer Plummer 3rd , Tony Ferguson, John Parrott, Thomas Robinson, GeoStar Corporation, First Source Wyoming, Inc. GeoStar Financial Services Corporation, Gastar Exploration Ltd., Zeus Investments, LLC and John Does 1-10 (Civil No. 080412334). This lawsuit was filed on July 7, 2008 in Utah state court by Craig S. Tillotson, or the Plaintiff, in which he alleges that he was fraudulently induced to invest in a mare leasing program operated by Classic Star LLC, a subsidiary of GeoStar, on the basis of certain verbal representations, and to convert interests in that program into shares of a working interest in the Powder River Basin. The Plaintiff asserts causes of action against all defendants including common law fraud, fraudulent inducement, statutory securities fraud under Utah state law, civil conspiracy, and negligent misrepresentation, and asserts certain additional causes of action only against GeoStar, a GeoStar affiliate, and the Plummers. The Company has not yet answered or otherwise responded. The Company intends to vigorously defend the suit.

Commitments

In March 2008, the Company entered into formal agreements with ETC Texas Pipeline, Ltd. (ETC) for the gathering, treating, purchase and transportation of the Company s natural gas production from the Hilltop area of East Texas. These agreements are effective September 1, 2007 and have a term of 10 years. ETC currently provides the Company 50 MMcfd of treating capacity and 120 MMcfd of gathering capacity. The Company has the right to request ETC build, at their cost, up to 150 MMcfd of treating and gathering capacity during the term of the agreement, provided that the Company s production equals 85% of the then existing treating and gathering capacity for a 30 day period. The Company may at any time elect to have its treating and gathering capacity increased subject to cost indemnifications to ETC.

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Additional treating and gathering capacity requests must be in at least 25 MMcfd and 5 MMcfd increments, respectively. In addition, the Company must furnish to ETC information that reasonably demonstrates that its projected production for the five years after expansion is sufficient to warrant the costs to create the expanded treating and gathering capacity. The incremental volume increases in treating and gathering capacity shall be subject to marginal increases in treating fees. Pursuant to the agreements, the Company has access up to 150 MMcfd of firm transportation on ETC s system or the pipelines of its affiliates or subsidiaries from the tailgate of the treating facility to Katy Hub. The Company has the option to sell and ETC has the obligation to buy, up to 150 MMcfd of the Company s Hilltop production at delivery points upstream of ETC s gathering and treating facilities. The Company does not have an obligation to deliver to ETC volumes in excess of 150 MMcfd, but should ETC elect to purchase such excess volumes, purchases will be subject to the treating and gathering expansion terms set forth in the agreements.

Registration Obligation

On November 29, 2007, Gastar USA sold $100.0 million aggregate principal amount of 12 $^{3}/4$% Senior Secured Notes at an issue price of 99.50% in a private placement to qualified institutional buyers. In connection with the sale, Gastar USA, the Company and all of Gastar USA s existing domestic subsidiaries entered into a registration rights agreement providing for the exchange of new notes registered under the Securities Act of 1933, as amended (the Securities Act). On August 4, 2008, the Company completed the exchange offer in which it issued $100.0 million aggregate principal amount of new 12 $^{3}/4$% Senior Secured Notes due 2012 registered under the Securities Act in exchange for all of the old notes.

14. Statement of Cash Flows Supplemental Information

The following is a summary of supplemental cash paid and non-cash transactions disclosed in the notes to the condensed consolidated financial statements:

	For the Six Months Ended June 30,	
	2008	2007
	(in thousands)	
Cash paid for interest	$ 8,069	$ 5,562
Non-cash transactions:		
Non-cash capital expenditures excluded from accounts payable and accrued drilling costs	$ (2,253)	$ 7,379
Asset retirement obligation included in oil and gas properties	$ 320	$ 1,109
Drilling advances application	$ 1,793	$ 3,035
Common shares issued under senior secured notes	$	$ 606
GeoStar settlement:		
Value of properties settled by assignment	$ 8,133	$
Warrant issued to GeoStar	$ 5,388	$
Future cash payment obligation	$ 3,256	$
Other non-cash settlements	$ (2,998)	$

Table of Contents

GASTAR EXPLORATION LTD. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

15. Issuer Subsidiaries Condensed Consolidating Financial Statements

The following tables present condensed consolidating balance sheets as of June 30, 2008 and December 31, 2007, and the related condensed consolidating statements of operations for the three and six months ended June 30, 2008 and 2007 and the condensed consolidating statements of cash flows for the six months ended June 30, 2008 and 2007 of Gastar Exploration Ltd. (Parent), Gastar Exploration USA, Inc. (Issuer) and Gastar Exploration Texas, Inc., Gastar Exploration Texas LP, Gastar Exploration Texas LLC, Gastar Exploration New South Wales, Inc., Gastar Exploration Victoria, Inc. and Gastar Power Pty Ltd., a minor non-guarantor subsidiary included in issuer subsidiaries, (collectively referred to as Issuer Subsidiaries). Each of the Parent and the Issuer Subsidiaries, except for Gastar Power Pty Ltd., have fully and unconditionally guaranteed, on a joint and severally basis, the $100.0 million 12 $^{3}/4$% Senior Secured Notes and the Revolving Credit Facility. During 2007, Parent intercompany receivables were reclassified to investment in subsidiary with Issuer and Issuer Subsidiaries. Prior to January 1, 2008, interest was not charged on intercompany receivables or payables. Total intercompany interest charged by Parent to Issuer during the three and six months ended June 30, 2008 were $17,000 and $29,000, respectively, which were eliminated in consolidation.

Table of Contents

Condensed Consolidating Parent and Issuer Subsidiaries Balance Sheets

As of June 30, 2008

(Unaudited)

ASSETS

	Parent	Issuer	Issuer Subsidiaries	Reclassifications and Eliminations	Gastar Exploration Ltd. and Subsidiaries
			(in thousands)		
CURRENT ASSETS:					
Cash and cash equivalents	$ 179	$	$ 41,837	$	$ 42,016
Accounts receivable, net	4		8,574		8,578
Due from related parties			1,873		1,873
Prepaid expenses	148	76	208		432
Total current assets	331	76	52,492		52,899
PROPERTY, PLANT AND EQUIPMENT:					
Natural gas and oil properties, full cost method of accounting:					
Unproved properties, not being amortized		9,550	101,217		110,767
Proved properties	8	47,986	230,099		278,093
Total natural gas and oil properties	8	57,536	331,316		388,860
Furniture and equipment			800		800
Total property, plant and equipment	8	57,536	332,116		389,660
Accumulated depreciation, depletion and amortization	(7)	(42,828)	(130,229)		(173,064)
Total property, plant and equipment, net	1	14,708	201,887		216,596
OTHER ASSETS:					
Restricted cash	25		46		71
Deferred charges, net	679	7,003			7,682
Drilling advances			2,009		2,009
Intercompany receivable and investment in subsidiaries	136,248	205,480		(341,728)	
Other assets		150	50		200
Total other assets	136,952	212,633	2,105	(341,728)	9,962
TOTAL ASSETS	$ 137,284	$ 227,417	$ 256,484	$ (341,728)	$ 279,457

LIABILITIES AND SHAREHOLDERS EQUITY

	Parent	Issuer	Issuer Subsidiaries	Reclassifications and Eliminations	Gastar Exploration Ltd. and Subsidiaries
CURRENT LIABILITIES:					
Accounts payable	$ 70	$	$ 10,935	$	$ 11,005
Revenue payable			8,103		8,103
Accrued interest	401	1,062			1,463
Accrued drilling and operating costs		2,145	3,433		5,578
Commodity derivative contracts		786	11,097		11,883
Other accrued liabilities	38	68	5,391		5,497
Due to related parties			3,800		3,800

Current portion of long-term debt	2,907				2,907
Total current liabilities	3,416	4,061	42,759		50,236
LONG-TERM LIABILITIES:					
Long-term debt	30,296	99,543			129,839
Asset retirement obligation	5	2,469	2,328		4,802
Commodity derivative contracts			2,620		2,620
Intercompany payable		2,379	23,282	(25,661)	
Total long-term liabilities	30,301	104,391	28,230	(25,661)	137,261
TOTAL SHAREHOLDERS EQUITY	103,567	118,965	185,495	(316,067)	91,960
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 137,284	$ 227,417	$ 256,484	$ (341,728)	$ 279,457

Table of Contents

Condensed Consolidating Parent and Issuer Subsidiaries Balance Sheets

As of December 31, 2007

ASSETS

	Parent	Issuer	Issuer Subsidiaries	Reclassifications and Eliminations	Gastar Exploration Ltd. and Subsidiaries
			(in thousands)		
CURRENT ASSETS:					
Cash and cash equivalents	$ 73	$	$ 85,781	$	$ 85,854
Accounts receivable, net	10	265	5,188	(635)	4,828
Due from related parties			904		904
Prepaid expenses	291		944		1,235
Total current assets	374	265	92,817	(635)	92,821
PROPERTY, PLANT AND EQUIPMENT:					
Natural gas and oil properties, full cost method of accounting:					
Unproved properties, not being amortized		2,988	66,856		69,844
Proved properties	8	43,611	203,753		247,372
Total natural gas and oil properties	8	46,599	270,609		317,216
Furniture and equipment			669		669
Total property, plant and equipment	8	46,599	271,278		317,885
Accumulated depreciation, depletion and amortization	(7)	(42,828)	(117,930)		(160,765)
Total property, plant and equipment, net	1	3,771	153,348		157,120
OTHER ASSETS:					
Restricted cash	1,029		45		1,074
Deferred charges, net	924	7,410			8,334
Drilling advances			2,251		2,251
Intercompany receivable and investment in subsidiaries	128,677	209,494		(338,171)	
Other assets		100	50		150
Total other assets	130,630	217,004	2,346	(338,171)	11,809
TOTAL ASSETS	$ 131,005	$ 221,040	$ 248,511	$ (338,806)	$ 261,750

LIABILITIES AND SHAREHOLDERS EQUITY

	Parent	Issuer	Issuer Subsidiaries	Reclassifications and Eliminations	Gastar Exploration Ltd. and Subsidiaries
CURRENT LIABILITIES:					
Accounts payable	$ 47	$	$ 11,954	$	$ 12,001
Revenue payable			6,770		6,770
Accrued interest	401	1,133			1,534
Accrued drilling and operating costs		350	2,460		2,810
Commodity derivative contracts		480			480
Other accrued liabilities	244	586	4,636	(635)	4,831
Due to related parties			979		979
Total current liabilities	692	2,549	26,799	(635)	29,405

LONG-TERM LIABILITIES:					
Long-term debt	33,179	99,506			132,685
Asset retirement obligation	5	2,289	2,097		4,391
Intercompany payable	589	1,615	26,668	(28,872)	
Total long-term liabilities	33,773	103,410	28,765	(28,872)	137,076
TOTAL SHAREHOLDERS EQUITY	96,540	115,081	192,947	(309,299)	95,269
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 131,005	$ 221,040	$ 248,511	$ (338,806)	$ 261,750

Table of Contents

Condensed Consolidating Parent and Issuer Subsidiaries Statements of Operations

For the Three Months Ended June 30, 2008

(Unaudited)

	Parent	Issuer	Issuer Subsidiaries	Reclassifications and Eliminations	Gastar Exploration Ltd. and Subsidiaries
			(in thousands)		
REVENUES:					
Natural gas and oil revenues	$	$ 3,744	$ 12,140	$	$ 15,884
Unrealized natural gas hedge loss		140	(653)		(513)
Total revenues		3,884	11,487		15,371
EXPENSES:					
Production taxes		421	53		474
Lease operating expenses		702	1,706		2,408
Transportation and treating		498			498
Depreciation, depletion and amortization			5,890		5,890
Accretion of asset retirement obligation		44	38		82
General and administrative expenses	292	(26)	3,798		4,064
Total expenses	292	1,639	11,485		13,416
INCOME (LOSS) FROM OPERATIONS	(292)	2,245	2		1,955
OTHER (EXPENSES) INCOME:					
Interest expense	(943)	(947)	1		(1,889)
Investment income and other	17	(7)	471		481
Equity earnings in subsidiaries	1,765	474		(2,239)	
Foreign transaction loss	(1)				(1)
INCOME BEFORE INCOME TAXES	546	1,765	474	(2,239)	546
Provision for income taxes					
NET INCOME	$ 546	$ 1,765	$ 474	$ (2,239)	$ 546

Table of Contents

Condensed Consolidating Parent and Issuer Subsidiaries Statements of Operations

For the Three Months Ended June 30, 2007

(Unaudited)

	Parent	Issuer	Issuer Subsidiaries	Reclassifications and Eliminations	Gastar Exploration Ltd. and Subsidiaries
			(in thousands)		
REVENUES:					
Natural gas and oil revenues	$	$ 1,328	$ 6,628	$	$ 7,956
Unrealized natural gas hedge loss					
Total revenues		1,328	6,628		7,956
EXPENSES:					
Production taxes		136	84		220
Lease operating expenses	1	693	820		1,514
Transportation and treating		339			339
Depreciation, depletion and amortization		1,634	3,809		5,443
Impairment of natural gas and oil properties		1,141	27,373		28,514
Accretion of asset retirement obligation		41	31		72
Mineral resource properties			(136)		(136)
General and administrative expenses	375	1	3,143		3,519
Total expenses	376	3,985	35,124		39,485
LOSS FROM OPERATIONS	(376)	(2,657)	(28,496)		(31,529)
OTHER (EXPENSES) INCOME:					
Interest expense	(3,968)		230		(3,738)
Investment income and other	1		771		772
Equity earnings in subsidiaries	8,723	11,380		(20,103)	
Gain on sale of unproved natural gas and oil properties			38,872		38,872
Foreign transaction gain			3		3
INCOME BEFORE INCOME TAXES	4,380	8,723	11,380	(20,103)	4,380
Provision for income taxes					
NET INCOME	$ 4,380	$ 8,723	$ 11,380	$ (20,103)	$ 4,380

Table of Contents

Condensed Consolidating Parent and Issuer Subsidiaries Statements of Operations

For the Six Months Ended June 30, 2008

(Unaudited)

	Parent	Issuer	Issuer Subsidiaries	Reclassifications and Eliminations	Gastar Exploration Ltd. and Subsidiaries
			(in thousands)		
REVENUES:					
Natural gas and oil revenues	$ 1	$ 6,878	$ 25,851	$	$ 32,730
Unrealized natural gas hedge loss		(76)	(1,850)		(1,926)
Total revenues	1	6,802	24,001		30,804
EXPENSES:					
Production taxes		769	(26)		743
Lease operating expenses		1,406	2,544		3,950
Transportation and treating		957			957
Depreciation, depletion and amortization			12,299		12,299
Accretion of asset retirement obligation		84	80		164
General and administrative expenses	589	16	7,734		8,339
Total expenses	589	3,232	22,631		26,452
INCOME (LOSS) FROM OPERATIONS	(588)	3,570	1,370		4,352
OTHER (EXPENSES) INCOME:					
Interest expense	(1,887)	(2,093)	(5)		(3,985)
Investment income and other	38	(17)	1,283		1,304
Equity earnings in subsidiaries	4,114	2,654		(6,768)	
Foreign transaction (loss) gain	(44)		6		(38)
INCOME BEFORE INCOME TAXES	1,633	4,114	2,654	(6,768)	1,633
Provision for income taxes					
NET INCOME	$ 1,633	$ 4,114	$ 2,654	$ (6,768)	$ 1,633

Table of Contents

Condensed Consolidating Parent and Issuer Subsidiaries Statements of Operations

For the Six Months Ended June 30, 2007

(Unaudited)

	Parent	Issuer	Issuer Subsidiaries	Reclassifications and Eliminations	Gastar Exploration Ltd. and Subsidiaries
			(in thousands)		
REVENUES:					
Natural gas and oil revenues	$ 1	$ 3,481	$ 11,989	$	$ 15,471
Unrealized natural gas hedge loss					
Total revenues	1	3,481	11,989		15,471
EXPENSES:					
Production taxes		370	144		514
Lease operating expenses	2	1,420	1,787		3,209
Transportation and treating		662			662
Depreciation, depletion and amortization		3,163	6,621		9,784
Impairment of natural gas and oil properties		1,141	27,373		28,514
Accretion of asset retirement obligation		81	57		138
Mineral resource properties					