

TENGASCO INC
Form 10-K
March 31, 2008
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

REPORT ON FORM 10-K

(Mark one)

Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended **December 31, 2007** or

Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from to .

Commission File No. 1-15555

TENGASCO, INC.

(Name of registrant as specified in its charter)

Tennessee

(State or other jurisdiction of
incorporation or organization)

87-0267438

(I.R.S. Employer
Identification No.)

10215 Technology Drive N.W., Knoxville, Tennessee 37932-3379

(Address of Principal Executive Offices) (Zip Code)

Registrant's telephone number, including area code:

(865) 675-1554.

Securities registered pursuant to Section 12(b) of the Act: **None.**

Securities registered pursuant to Section 12(g) of the Act: **Common Stock, \$.001 par value per share.**

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined by Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

Large Accelerated Filer

Accelerated Filer

Non-accelerated Filer
(Do not check if a Smaller
Reporting Company)

Smaller Reporting Company

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter (June 29, 2007 closing price \$0.65): **\$24,375,566**

State the number of shares outstanding of the registrant's \$.001 par value common stock as of the close of business on the latest practicable date (March 3, 2008): **59,155,750**

Documents Incorporated By Reference

The information required by Part III of the Form 10-K, to the extent not set forth herein, is incorporated herein by reference from the registrant's definitive proxy statement for the Annual Meeting of Shareholders to be held on June 2, 2008, to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the close of the registrant's fiscal year.

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FORWARD LOOKING STATEMENTS

The information contained in this Report, in certain instances, includes forward-looking statements within the meaning of applicable securities laws. Forward-looking statements include statements regarding the Company's "expectations," "anticipations," "intentions," "beliefs," or "strategies" regarding the future. Forward-looking statements also include statements regarding revenue, margins, expenses, and earnings analysis for 2007 and thereafter; oil and gas prices; exploration activities; development expenditures; costs of regulatory compliance; environmental matters; technological developments; future products or product development; the Company's products and distribution development strategies; potential acquisitions or strategic alliances; liquidity and anticipated cash needs and availability; prospects for success of capital raising activities; prospects or the market for or price of the Company's common stock; and control of the Company. All forward-looking statements are based on information available to the Company as of the date hereof, and the Company assumes no obligation to update any such forward-looking statements. The Company's actual results could differ materially from the forward-looking statements. Among the factors that could cause results to differ materially are the factors discussed in "Risk Factors" below in Item 1A of this Report.

Projecting the effects of commodity prices on production and timing of development expenditures includes many factors beyond the Company's control. The future estimates of net cash flows from the Company's proved reserves and their present value are based upon various assumptions about future production levels, prices, and costs that may prove to be incorrect over time. Any significant variance from assumptions could result in the actual future net cash flows being materially different from the estimates.

PART I

ITEM 1.

BUSINESS.

History of the Company

The Company was initially organized in Utah in 1916 for the purpose of mining, reducing and smelting mineral ores, under the name Gold Deposit Mining & Milling Company and later changed to Onasco Companies, Inc. In 1995, the Company changed its name from Onasco Companies, Inc. by merging into Tengasco, Inc., a Tennessee corporation, formed by the Company solely for this purpose.

Overview

The Company is in the business of exploring for, producing and transporting oil and natural gas in Kansas and Tennessee. The Company leases producing and non-producing

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properties with a view toward exploration and development and owns pipeline and other infrastructure facilities used to provide transportation services. The Company utilizes seismic technology to improve the discovery of reserves.

In 1998, the Company acquired from AFG Energy, Inc. ("AFG"), a private company, approximately 32,000 acres of leases in the vicinity of Hays, Kansas (the "Kansas Properties"). Included in that acquisition were 273 wells, including 208 working wells, of which 149 were producing oil wells and 59 were producing gas wells, a related 50-mile pipeline and gathering system, three compressors and 11 vehicles. The Company sold the Kansas gas producing wells, gathering system and compressors effective February 1, 2005. During 2007, the Kansas Properties produced an average of 14,860 barrels of oil per month.

The Company's oil and gas leases in Tennessee are located in Hancock, Claiborne, and Jackson counties. The Company has drilled primarily on a portion of its leases known as the Swan Creek Field in Hancock County focused within what is known as the Knox Formation, one of the geologic formations in that field. During 2007 the Company sold an average of 347 thousand cubic feet of natural gas per day and 573 barrels of oil per month from 21 producing gas wells and 5 producing oil wells in the Swan Creek Field.

The Company's wholly-owned subsidiary, Tengasco Pipeline Corporation ("TPC"), owns and operates a 65-mile intrastate pipeline which it constructed to transport natural gas from the Company's Swan Creek Field to customers in Kingsport, Tennessee.

The Company formed a wholly-owned subsidiary on December 27, 2006 named Manufactured Methane Corporation for the purpose of owning and operating treatment and delivery facilities using the latest developments in available technologies for the extraction of methane gas from non-conventional sources for delivery through the nation's existing natural gas pipeline system, including the Company's TPC pipeline system in Tennessee for eventual sale to natural gas customers.

In December 2007 the Company entered into a management agreement with Hoactzin Partners, L.P. ("Hoactzin") to manage Hoactzin's oil and gas properties in the Gulf of Mexico offshore Texas and Louisiana. As consideration for that agreement the Company obtained reimbursement from Hoactzin of a portion of salary and expenses for the Company's Vice President Patrick McInturff, as well as an option to participate in production and exploration activities in Hoactzin's properties and has begun investigating the economics of participation in oil and gas projects in those areas. Peter E. Salas, the Chairman of the Board of Directors of the Company, is the controlling person of Hoactzin. He is also the sole shareholder and controlling person of Dolphin Management, Inc., the general partner of Dolphin Offshore Partners, L.P., which is the Company's largest shareholder.

General

1. The Kansas Properties

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The Company's Kansas Properties presently include 149 producing oil wells in the vicinity of Hays, Kansas. The Company employs a full time geologist in Kansas to oversee acquisition of new properties, and exploration and exploitation of Kansas Drilling prospects on both newly acquired acreage and existing leases for development. The Company employs a full time production manager to oversee the daily function of all producing wells and to implement the work-over programs employed by the Company to boost production from older wells.

In 2007, the Company continued to focus its exploration and drilling activities in Kansas. In 2007, the Company drilled 16 new wells on its Kansas Properties, of which 9 wells were under the ten well program discussed below in greater detail. Of these new wells, 10 are producing commercial quantities of oil. These new wells are producing approximately 135 barrels of oil per day. The Company also continued in 2007 its program of work-overs of existing wells to increase production. The Company's focus in 2007 on its Kansas oil production and the results achieved by the Company from its ongoing operations, drilling and work-overs are having a positive impact on the Company's reserves resulting in the Company's total proved reserves at December 31, 2007 having more than doubled in value from year-end 2006. Fifty-Six (56%) percent of that increase in reserve growth is attributable to the Company's ongoing operational activities and the new Proved Undeveloped (PUD) future drilling locations that the Company has established as a result of these successes. See, Item 2, "Properties" – "Reserve Analysis" for a more detailed discussion of the Company's reserves.

During 2007, the Company also continued its lease acquisition program in Kansas to acquire oil and gas leases in areas near its previous lease holdings where the Company believes there is a likelihood of additional oil production. The Company continued to collect and analyze substantial seismic data to aid it in its drilling operations. The Company intends in 2008 to continue to acquire additional leases in the area of its existing wells.

A. Kansas Drilling Programs

1. The Ten Well Program

On September 17, 2007, the Company entered into a drilling program with Hoactzin for ten wells consisting of approximately three wildcat wells and seven developmental wells to be drilled on the Company's Kansas Properties (the "Program"). Under the terms of the Program, Hoactzin was to pay the Company \$400,000 for each well in the Program completed as a producing well and \$250,000 per drilled well that was non-productive. The terms of Program also provide that Hoactzin will receive all the working interest in the ten wells in the Program, but will pay an initial fee to the Company of 25% of its working interest revenues net of operating expenses. This is referred to as a management fee but as defined is in the nature of a net profits interest. The fee paid to the Company by Hoactzin will increase to 85% of working interest revenues when net revenues received by Hoactzin reach an agreed payout point of

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approximately 1.35 times Hoactzin's purchase price (the "Payout Point"). The Company intends to account for funds received for interests in the Program as an offset to oil and gas properties.

As of the date of this Report, the Company has drilled all ten wells in the Program. Of the ten wells drilled, nine were completed as oil producers and are currently producing approximately 106 barrels per day in total. Hoactzin paid a total of \$3,850,000 for its interest in the Program resulting in the Payout Point being determined as \$5,215,595. The amount paid by Hoactzin for its interest in the Program wells exceeded the Company's actual drilling costs of approximately \$2.8 million for the ten wells by more than \$1 million.

Although production level of the Program wells will decline with time in accordance with expected decline curves for these types of well, based on the drilling results of the Program wells and the current price of oil, the Program wells are expected to reach the Payout Point in approximately four years solely from the oil revenues from the wells. However, under the terms of its agreement with Hoactzin reaching the Payout Point could be accelerated by the application of 75% of the net proceeds Hoactzin receives from the methane extraction project being developed by the Company's wholly-owned subsidiary, Manufactured Methane Corporation, at the Carter Valley, Tennessee landfill toward reaching the Payout Point. (The methane extraction project is discussed in greater detail below.) Those methane project proceeds when applied will result in the Payout Point being achieved sooner than the estimated four year period based solely upon revenues from the Program wells.

2. The Eight Well Program

In 2006, the Company drilled the last two wells of an eight-well drilling program in Kansas (the "Eight Well Program"). The Eight Well Program was offered to the holders of the Company's Series A 8% Cumulative Convertible Preferred Stock ("Series A Shares") in exchange for their Series A Shares. This resulted in the participants acquiring approximately an 81% working interest in the eight wells and the Company retaining the remaining 19% working interest. Under the terms of the Eight Well Program, the former Series A shareholders participating in the Eight Well Program were to receive all of the cash flow from their 81% working interest in the eight wells until they recovered 80% of the face value of the Series A Shares they exchanged for their interests in the Eight Well Program. At that point, for the rest of the productive lives of those eight wells, the Company will receive 85% of the cash flow from the 81% working interest in those wells as a management fee and the Series A shareholders will receive the remaining 15% of the cash flow. The Eight Well Program has produced sufficient revenues to the participants so that the management fee to the Company became due in 2007. This had the effect of increasing the Company's net interest in the Program Wells from approximately 19% to an effective 88% interest and resulting in approximately an additional \$50,000 in revenues per month to the Company's interest in those wells.

3. The Twelve Well Program

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In October, 2005 the Company accepted an exchange from Hoactzin of promissory notes made by the Company in the principal amount of \$2,514,000 for a 94.3% working interest in a twelve well drilling program (the "Twelve Well Program") by the Company on its Kansas Properties. The Company retained the remaining 5.7% working interest in the Twelve Well Program. The promissory notes exchanged were originally issued by the Company in connection with loans made to the Company by Dolphin Offshore Partners, L.P. to fund the Company's cash exchange to holders of its Series A, B and C Preferred Stock.

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In 2006, the Company drilled four wells in the Twelve Well Program bringing the total number of wells drilled in that Program to six. All but one of those wells is continuing to produce commercial quantities of oil.

On June 29th, 2006 the Company closed a \$50,000,000 credit facility with Citibank Texas, N.A. The Company's initial borrowing base was set at \$2,600,000 and the Company borrowed that amount on June 29, 2006 and used \$1.393 million of the loan proceeds to exercise its option to repurchase from Hoactzin, the Company's obligation to drill the final six wells in the Company's Twelve Well Program. As a result of the repurchase, the Twelve Well Program was converted to a six well program, all of which had been drilled by the Company at the time of the repurchase. Consequently, all well-drilling obligations of the Company under both the Eight Well and Twelve Well Programs with former preferred stockholders as participants have been satisfied. If the Company had not exercised its repurchase option, Hoactzin would have received a 94% working interest in the final six wells of the Twelve Well Program. However, as a result of the repurchase, Hoactzin will now receive only a 6.25% overriding royalty in six Company wells to be drilled, plus an additional 6.25% overriding royalty in the six program wells that had previously been drilled as part of the Twelve Well Program. These overriding royalties were part of the terms agreed upon at the inception of the Twelve Well Program if the repurchase option was exercised.

B. Kansas Production

Gross oil production in 2007 was just slightly less than 2006 resulting from the loss of production in January 2007 due to an electricity outage caused by an ice storm. As a result of that storm, many counties in Kansas, including some counties where the Company has wells, lost power for the entire month of January. Producing wells in those counties were unable to produce without electricity to run the well pumps during the power outage. Consequently, in January 2007 the Company saw production and revenue decline from monthly levels in late 2006. None of the Company's producing wells were physically damaged by the ice storm or by non-production during the absence of power, but the storm did substantially adversely impact production levels and sales in the first two months of 2007 while at the same time causing an increase in expenses. Eventually new poles and lines were rebuilt on a locally massive scale and electrical power was restored, and the Company experienced a rebound of production commencing in March 2007. In 2007, the Company produced 178,311 barrels of oil in Kansas compared to 179,555 in 2006, a decrease of 1,244 barrels for the year. Additionally, the wells in the Eight Well Program reached the reversionary "flip point" in April 2007. This is the point at

which the Company started receiving 85% of the participant's interest plus the Company's original interest of (19.6%) for an approximate total net interest to the Company equal to an 88% working interest. In 2007, the wells from the Eight Well Program produced 22,195 gross barrels of oil; the wells in the Twelve Well Program (now converted to a six well program) produced 15,864 gross barrels; wells that were polymered produced 19,502 barrels; and the two new wells drilled produced 2,566 gross barrels in 2007. The Ten Well Program had some limited production in 2007 as wells were being completed through the year-end. During 2007, the Ten Well Program produced 3,649 barrels from 5 wells that were completed by year-end. The five other wells in the Ten Well Program that were drilled in 2007 were completed in 2008. In March 2008 the tenth and final well from the Ten Well Program was drilled and completed as a producer. As of the date of this Report, nine of ten wells drilled in the Program have been completed as producers and are producing approximately 106 barrels per day. During the first half of 2008 the Company expects the reversionary flip point for the Twelve Well Program now converted to a six well program, to be achieved.

There are also additional capital development projects that the Company is considering to increase current oil production with respect to the Kansas Properties, including recompletion of wells and major work-overs. Management has made the decision to simultaneously undertake as many of these projects that can be paid from the Company's current cash flow as soon as the Company is able to obtain third party crews and equipment to perform the work. Workovers done to date on a limited scale have been successful in Kansas. The work-overs included a treatment of wells by injection of polymers (a type of plastic compound) that has sealed off almost all of the water from entering the combined oil/water fluid stream that is naturally produced from the wells, while at the same time increasing the total quantity of crude oil that is actually produced per day from the treated wells. Although there can be no assurances, similar work-overs when completed might reduce water production and its associated removal expense and increase oil production from several of the Company's other existing oil wells in Kansas.

2. The Tennessee Properties

Amoco Production Company, during the late 1970's and early 1980's acquired approximately 50,500 acres of oil and gas leases in the Eastern Overthrust in the Appalachian Basin, including the area now referred to as the Swan Creek Field. In 1982, Amoco successfully drilled two natural gas discovery wells in the Swan Creek Field to the Knox Formation. These wells, once completed, had a high pressure and apparent volume of deliverability of natural gas. In the mid-1980's, however, development of this Field was cost prohibitive due to a substantial decline in worldwide oil and gas prices which was further exacerbated by the high cost of constructing a necessary 23-mile pipeline across three mountain ranges and crossing the environmentally protected Clinch River from Sneedville, Tennessee to deliver gas from the Swan Creek Field to the closest market in Rogersville, Tennessee. In July 1995, the Company concluded a legal action under state law and acquired the Swan Creek leases.

A. Swan Creek Pipeline Facilities

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The Company completed Phase I of its pipeline from the Swan Creek Field, a 30-mile pipeline made of six and eight-inch steel pipe running from the Swan Creek Field into the main city gate of Rogersville, Tennessee in 1998. The cost of constructing Phase I of the pipeline was approximately \$4,200,000. Construction of Phase II of the Company's pipeline system was completed in 2001. Phase II was an additional 35 miles of eight and 12-inch pipe laid at a cost of approximately \$12.1 million, extending the Company's pipeline from a point near the terminus of Phase I and connecting to a meter station at Eastman Chemical Company's ("Eastman") plant in Kingsport, Tennessee. The completed pipeline system extends 65 miles from the Company's Swan Creek Field to Kingsport, Tennessee and was built for a total cost of \$16,329,552.

B. Swan Creek Production and Development

Management obtained state regulatory approval in 2003 for drilling additional infield wells in the Swan Creek Field resulting in an increased density of wells. At that time, management expected that an increased density of wells within the existing Swan Creek Field would result in additional reserves in accordance with reservoir engineering standards.

Thereafter, the Company drilled and tested two new infield development wells in the Swan Creek Field. The results of these wells together with the accumulation of data from previously drilled wells and seismic data indicated that drilling new gas wells in the Swan Creek Field would not achieve any significant increase in daily gas production totals from the Field; the current wells in production in the Swan Creek Field would be capable of and would likely produce all the remaining reserves in that Field; and, that only limited additional gas reserves could be added with additional infield developmental drilling. Consequently, the Company has not drilled any new wells in the Swan Creek Field since 2004.

Because no drilling for natural gas directly in Swan Creek is anticipated in the future, the current production levels less decline are the sole value of natural gas reserves and production. The existing production and the current 21 wells producing natural gas are showing typical Appalachian production declines, which exhibit a long-lived nature but more modest volumes. The experienced decline in actual production levels from existing wells in the Swan Creek Field from 2006 to 2007 was expected and predictable. Although there can be no assurance, the Company expects these natural rates of decline in the future will be comparable to the decline experienced over the 2006-2007 period, and that ongoing production from existing wells will tend to stabilize near current production levels. Variations in year-end natural gas prices and lack of interest to invest in Swan Creek in the foreseeable future have resulted in an adjustment to the reserve volumes to reflect only the reserves associated with currently producing wells. The company maintains an interest and anticipates drilling additional oil prospects in Swan Creek. It also has an interest in seeking other exploration targets in Tennessee outside of Swan Creek but near the Company's pipeline, with other industry partners.

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The deliverability of natural gas from the Swan Creek Field will not be sufficient to satisfy the volumes deliverable under its contracts with Eastman and BAE in Kingsport, Tennessee. The Eastman contract provides that Eastman will buy a minimum of the lesser of eighty percent of that customer's daily usage or 10,000 MMBtu per day, and the BAE contract provides that BAE will buy a minimum of all of that customer's usage or 5,000 MMBtu per day after Eastman's volumes have been provided. In 2007, the Company's volume sold from the field was approximately 347 MMBtu per day. The Company's contracts with these customers are only for natural gas produced from the Swan Creek Field. So long as that field is not capable of supplying these volumes of natural gas, the Company is not in breach or violation of these contracts. No penalty is associated with the inability of the Field to produce the volumes that the Company could deliver and buyers would be obligated to buy under its industrial contracts if the volumes were physically available from the Field. However, in the event that the Company were found to be in breach of its obligations for failure to deliver any volumes of gas that is produced from the Swan Creek Field to either of these customers, the agreements limit potential exposure to damages. Damages are limited to no more than \$.40 per MMBtu for any replacement volumes that are proved in a court proceeding as having been obtained to replace volumes required to be furnished but not furnished by the Company.

During 2007, the Company had 21 producing gas wells and 5 producing oil wells in the Swan Creek Field. Sales from the Swan Creek Field during 2007 averaged 347 Mcf per day compared to 378 Mcf per day in 2006.

3. The Methane Project

On October 24, 2006 the Company signed a twenty-year Landfill Gas Sale and Purchase Agreement (the "Agreement") with BFI Waste Systems of Tennessee, LLC ("BFI"), an affiliate of Allied Waste Industries. The Agreement was thereafter assigned to the Company's wholly-owned subsidiary, Manufactured Methane Corporation ("MMC") and provides that MMC will purchase all the naturally produced gas stream presently being collected and flared at the municipal solid waste landfill in Carter Valley serving the metropolitan area of Kingsport, Tennessee that is owned and operated by BFI in Church Hill, Tennessee. BFI's facility is located about two miles from the Company's existing pipeline serving Eastman Chemical Company ("Eastman"). Contingent upon obtaining suitable financing, the Company plans to acquire and install a proprietary combination of advanced gas treatment technology to extract the methane component of the purchased gas stream. Methane is the principal component of natural gas and makes up about half of the purchased gas stream by volume. The Company plans to construct a small diameter pipeline to deliver the extracted methane gas to the Company's existing pipeline for delivery to Eastman (the "Methane Project").

MMC has placed equipment orders for its first stage of process equipment (cleanup and carbon dioxide removal) and the second stage of process equipment (nitrogen rejection) for the Methane Project. It is anticipated that the total costs for the Project including pipeline construction, will be approximately \$4.1 million including costs for compression and interstage controls. The costs of the Methane Project to date have been funded primarily by (a)

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the money received by the Company from Hoactzin to purchase its interest in the Ten Well Program which exceeded the Company's actual costs of drilling the wells in that Program by more than \$1 million (b) cash flow from the Company's operations in the amount of approximately \$1 million and (c) \$825,000 of the funds the Company borrowed from its credit facility with Sovereign Bank. The Company anticipates that most of the remaining balance of the Methane Project costs will be paid from the Company's cash flow.

The Company anticipates that the equipment ordered by MMC will be manufactured and delivered to allow operations to begin in mid-2008 after equipment installation, testing, and startup procedures are begun. Commercial deliveries of gas will begin when the equipment is installed and tested, the pipeline is constructed and emission permits are obtained. Upon commencement of operations, the methane gas produced by the project facilities will be mixed in the Company's pipeline and delivered and sold to Eastman Chemical Company ("Eastman") under the terms of the Company's existing natural gas purchase and sale agreement. At current gas production rates and expected extraction efficiencies, when commercial operations of the Project begin, the Company would expect to deliver about 418 MMBtu per day of additional gas to Eastman, which would substantially increase the current volumes of natural gas being delivered to Eastman by the Company from its Swan Creek field. At an assumed sales price of gas of \$7 per MMBtu, near the average natural gas price received by the Company in 2007, the anticipated net revenues would be approximately \$800,000 per year from the Methane Project based on anticipated volumes and expenses. The gas supply from this project is projected to grow over the years as the underlying operating landfill continues to expand and generate additional naturally produced gas, and for several years following the closing of the landfill, currently estimated by BFI to occur between the years 2022 and 2026.

As part of the Methane Project agreement, the Company agreed to install a new force-main water drainage line for BFI, the landfill owner, in the same two-mile pipeline trench as the gas pipeline needed for the project, reducing overall costs and avoiding environmental effects to private landowners resulting from multiple installations of pipeline. BFI will pay the additional costs for including the water line. Construction of the gas pipeline needed to connect the facility with the Company's existing natural gas pipeline began in January 2008. As a certificated utility, the Company's pipeline subsidiary, TPC, requires no additional permits for the gas pipeline construction. The Company currently anticipates that pipeline construction will be concluded approximately the same time as equipment deliveries and installations occur or in the May to June 2008 time period, subject to weather delays during wintertime construction.

On September 17, 2007, Hoactzin, simultaneously with subscribing to participate in the Ten Well Program, pursuant to a separate agreement with the Company was conveyed a 75% net profits interest in the Methane Project. When the Methane Project comes online, the revenues from the Project received by Hoactzin will be applied towards the determination of the Payout Point (as defined above) for the Ten Well Program. When the Payout Point is reached from either the revenues from the wells drilled in the Program or the Methane Project or a combination thereof, Hoactzin's net profits interest in the Methane Project will decrease to a 7.5% net profits interest. The Company believes that the application of revenues from the

methane project to reach the Payout Point could accelerate reaching the Payout Point. As stated above, the price paid by Hoactzin for its interest in the Program exceeded the Company's anticipated and actual costs of drilling the ten wells in the Program. Those excess funds provided by Hoactzin were used to pay for approximately \$1,000,000 of equipment required for the Methane Project, or about 25% of the Project's capital costs. The availability of the funds provided by Hoactzin eliminated the need for the Company to borrow those funds, to have to pay interest to any lending institution making such loans or to dedicate Company revenues or revenues from the Methane Project to pay such debt service. Accordingly, the grant of a 7.5% interest in the Methane Project to Hoactzin was negotiated by the Company as a favorable element to the Company of the overall transaction.

4.

Management Agreement with Hoactzin

On December 18, 2007, the Company entered into a Management Agreement with Hoactzin. On that same date, the Company also entered into an agreement with Charles Patrick McInturff employing him as a Vice-President of the Company. Pursuant to the Management Agreement with Hoactzin, Mr. McInturff's duties while he is employed as Vice-President of the Company will include the management on behalf of Hoactzin of its working interests in certain oil and gas properties owned by Hoactzin and located in the onshore Texas Gulf Coast, and offshore Texas and offshore Louisiana. As consideration for the Company entering into the Management Agreement, Hoactzin has agreed that it will be responsible to reimburse the Company for the payment of one-half of Mr. McInturff's salary, as well as certain other benefits he receives during his employment by the Company. In further consideration for the Company's agreement to enter into the Management Agreement, Hoactzin has granted to the Company an option to participate in up to a 15% working interest for a corresponding price of up to 15% of the actual project costs, in any new drilling or work-over activities undertaken on Hoactzin's managed properties during the term of the Management Agreement. The term of the Management Agreement is the earlier of the date Hoactzin sells its interests in its managed properties or 5 years.

5. Other Areas of Development

The Company is seeking to purchase and has attempted to acquire additional existing oil and gas production in the Mid-Continent (USA) area. The Company is particularly interested in areas of Kansas, Oklahoma, and Texas. Although financing plans are uncertain, management believes that when a suitable property becomes available, a combination of such a property with our current reserves would allow the Company to create a financing mechanism that would make a purchase of the property possible. However, there is no assurance that a suitable property will become available or that terms will be established leading to a completion of such a purchase.

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The Company has evaluated other geological structures in the East Tennessee area that are similar to the Swan Creek Field. These target evaluations were made using available third party seismic data, the Company's own seismic investigations, and drilling results and geophysical logs from the existing wells in the region. While these areas are of interest, and may be further evaluated at some future time, based on its review to date the Company does not currently intend to actively explore these areas with its own funds. However, the Company may consider entering into partnerships where further exploration and drilling costs can be largely borne by third parties. There can be no assurances that any third party would participate in a drilling program in these structures, that any of these prospects will be drilled, and if they were drilled that they would result in commercial production

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The Company also intends to establish and explore all business opportunities for connection of the pipeline system owned by the Company's subsidiary TPC to other sources of natural gas or gas produced from non-conventional sources so that revenues from third parties for transportation of gas across the pipeline system may be generated. Although no assurances can be made, such connections may also enable the Company to purchase natural gas from other sources and to then market natural gas to new customers in the Kingsport, Tennessee area at retail rates under a franchise agreement already granted to the Company by the City of Kingsport, subject to approval by the Tennessee Regulatory Authority.

The Company also intends to continue to explore other opportunities such as its Methane Project in Church Hill, Tennessee to obtain natural gas or substitutes for natural gas from non-conventional sources if such gas can be economically treated and tendered in commercial volumes for transportation not only through the Company's existing pipeline system but by other delivery mechanisms and through other interstate or intrastate pipelines or local distribution companies for the purposes of supplementing the Company's revenues from the sale of the methane gas produced by these projects.

Governmental Regulations

The Company is subject to numerous state and federal regulations, environmental and otherwise, that may have a substantial negative effect on its ability to operate at a profit. For a discussion of the risks involved as a result of such regulations, see, "Effect of Existing or Probable Governmental Regulations on Business" and "Costs and Effects of Compliance with Environmental Laws" hereinafter in this section.

Principal Products or Services and Markets

The principal markets for the Company's crude oil are local refining companies, local utilities and private industry end-users. The principal markets for the Company's natural gas are local utilities, private industry end-users, and natural gas marketing companies.

Gas production from the Swan Creek Field can presently be delivered through the