FOREST OIL CORP
Form 10-Q
May 02, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
T QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2012

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 1-13515

FOREST OIL CORPORATION
(Exact name of registrant as specified in its charter)

New York (State or other jurisdiction of incorporation or organization)	25-0484900 (I.R.S. Employer Identification No.)
707 17th Street, Suite 3600 Denver, Colorado (Address of principal executive offices)	80202 (Zip Code)

Registrant’s telephone number, including area code: (303) 812-1400
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. T Yes ¨ No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). T Yes ¨ No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

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

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

As of April 25, 2012 there were 117,768,821 shares of the registrant’s common stock, par value $.10 per share, outstanding.

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March 31, 2012

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PART I—FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

FOREST OIL CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In Thousands, Except Share Amounts)

	March 31, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$877	$3,012
Accounts receivable	72,734	79,089
Derivative instruments	107,500	89,621
Other current assets	40,241	38,950
Total current assets	221,352	210,672
Property and equipment, at cost:		
Oil and gas properties, full cost method of accounting:		
Proved, net of accumulated depletion of $7,002,621 and $6,901,997	2,063,359	1,923,145
Unproved	666,382	675,995
Net oil and gas properties	2,729,741	2,599,140
Other property and equipment, net of accumulated depreciation and amortization of $49,574 and $47,989	52,470	51,976
Net property and equipment	2,782,211	2,651,116
Deferred income taxes	229,293	231,116
Goodwill	239,420	239,420
Derivative instruments	22,040	10,422
Other assets	36,958	38,405
	$3,531,274	$3,381,151
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$224,502	$247,880
Accrued interest	28,669	23,259
Derivative instruments	45,467	28,944
Deferred income taxes	19,667	20,172
Other current liabilities	46,005	20,582
Total current liabilities	364,310	340,837
Long-term debt	1,804,481	1,693,044
Asset retirement obligations	75,659	77,898
Derivative instruments	7,663	—
Other liabilities	76,757	76,259
Total liabilities	2,328,870	2,188,038
Shareholders’ equity:		
Preferred stock, none issued and outstanding	—	—
Common stock, 117,741,791 and 114,525,673 shares issued and outstanding	11,774	11,454
Capital surplus	2,528,451	2,486,994
Accumulated deficit	(1,319,736)	(1,287,063)
Accumulated other comprehensive loss	(18,085)	(18,272)

Total shareholders' equity	1,202,404	1,193,113
	$3,531,274	$3,381,151

See accompanying Notes to Condensed Consolidated Financial Statements.

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FOREST OIL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In Thousands, Except Per Share Amounts)

	Three Months Ended March 31, 2012	2011
Revenues:		
Oil, natural gas, and natural gas liquids sales	$158,901	$166,310
Interest and other	32	552
Total revenues	158,933	166,862
Costs, expenses, and other:		
Lease operating expenses	27,607	23,630
Production and property taxes	11,153	11,606
Transportation and processing costs	3,972	3,651
General and administrative	15,384	15,820
Depreciation, depletion, and amortization	66,970	48,544
Ceiling test write-down of natural gas properties	34,817	—
Interest expense	33,392	38,037
Realized and unrealized (gains) losses on derivative instruments, net	(29,524)	36,246
Other, net	26,920	3,622
Total costs, expenses, and other	190,691	181,156
Loss from continuing operations before income taxes	(31,758)	(14,294)
Income tax	915	(4,373)
Net loss from continuing operations	(32,673)	(9,921)
Net earnings from discontinued operations	—	6,591
Net loss	$(32,673)	$(3,330)
Basic earnings (loss) per common share:		
Loss from continuing operations	$(.29)	$(.09)
Earnings from discontinued operations	—	.06
Basic loss per common share	$(.29)	$(.03)
Diluted earnings (loss) per common share:		
Loss from continuing operations	$(.29)	$(.09)
Earnings from discontinued operations	—	.06
Diluted loss per common share	$(.29)	$(.03)

See accompanying Notes to Condensed Consolidated Financial Statements.

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FOREST OIL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)
(In Thousands)

	Three Months Ended March 31,	
	2012	2011
Net loss	$(32,673)	$(3,330)
Other comprehensive income:		
Foreign currency translation gains	—	7,926
Unfunded postretirement benefits, net of tax	187	289
Total other comprehensive income	187	8,215
Total comprehensive income (loss)	$(32,486)	$4,885

See accompanying Notes to Condensed Consolidated Financial Statements.

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FOREST OIL CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF EQUITY
(Unaudited)
(In Thousands)

	Common Stock		Capital Surplus	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
	Shares	Amount				
Balances at December 31, 2011	114,526	$11,454	$2,486,994	$(1,287,063)	$(18,272)	$1,193,113
Common stock issued for acquisition of unproved oil and natural gas properties	2,657	266	36,165	—	—	36,431
Employee stock purchase plan	35	3	356	—	—	359
Restricted stock issued, net of forfeitures	528	53	(53)	—	—	—
Amortization of stock-based compensation	—	—	5,115	—	—	5,115
Other, net	(4)	(2)	(126)	—	—	(128)
Net loss	—	—	—	(32,673)	—	(32,673)
Other comprehensive income	—	—	—	—	187	187
Balances at March 31, 2012	117,742	$11,774	$2,528,451	$(1,319,736)	$(18,085)	$1,202,404

See accompanying Notes to Condensed Consolidated Financial Statements.

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FOREST OIL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In Thousands)

	Three Months Ended March 31,	
	2012	2011
Operating activities:		
Net loss	$(32,673)	$(3,330)
Less: net earnings from discontinued operations	—	6,591
Net loss from continuing operations	(32,673)	(9,921)
Adjustments to reconcile net loss from continuing operations to net cash provided by operating activities of continuing operations:		
Depreciation, depletion, and amortization	66,970	48,544
Deferred income tax	1,133	(3,974)
Unrealized (gains) losses on derivative instruments, net	(5,312)	49,784
Ceiling test write-down of natural gas properties	34,817	—
Stock-based compensation expense	3,017	4,473
Accretion of asset retirement obligations	1,598	1,449
Other, net	2,356	1,858
Changes in operating assets and liabilities:		
Accounts receivable	6,355	20,308
Other current assets	(424)	(166)
Accounts payable and accrued liabilities	(11,538)	(3,145)
Accrued interest and other current liabilities	27,260	10,488
Net cash provided by operating activities of continuing operations	93,559	119,698
Investing activities:		
Capital expenditures for property and equipment:		
Exploration, development, and leasehold acquisition costs	(187,122)	(168,166)
Other fixed assets	(2,512)	(1,875)
Proceeds from sales of assets	899	11,614
Net cash used by investing activities of continuing operations	(188,735)	(158,427)
Financing activities:		
Proceeds from bank borrowings	202,000	—
Repayments of bank borrowings	(92,000)	—
Change in bank overdrafts	(17,284)	16,483
Other, net	325	384
Net cash provided by financing activities of continuing operations	93,041	16,867
Cash flows of discontinued operations:		
Operating cash flows	—	26,253
Investing cash flows	—	(57,791)
Financing cash flows	—	(1,561)
Net cash used by discontinued operations	—	(33,099)
Effect of exchange rate changes on cash	—	124
Net decrease in cash and cash equivalents	(2,135)	(54,837)
Net increase in cash and cash equivalents of discontinued operations	—	(1,807)
Net decrease in cash and cash equivalents of continuing operations	(2,135)	(56,644)
Cash and cash equivalents of continuing operations at beginning of period	3,012	217,569

Cash and cash equivalents of continuing operations at end of period	$877	$160,925
Cash paid by continuing operations during the period for:		
Interest (net of capitalized amounts)	$25,058	$24,279
Income taxes (net of refunded amounts)	(114)	53
Non-cash investing activities of continuing operations:		
Increase in accrued capital expenditures	$5,444	$18,174
Increase in asset retirement costs	1,066	77
Common stock issued for acquisition of unproved oil and natural gas properties	36,431	—

See accompanying Notes to Condensed Consolidated Financial Statements.

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FOREST OIL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(1) ORGANIZATION AND BASIS OF PRESENTATION

Organization

Forest Oil Corporation is an independent oil and gas company engaged in the acquisition, exploration, development, and production of oil, natural gas, and natural gas liquids ("NGLs") primarily in the United States. Forest was incorporated in New York in 1924, as the successor to a company formed in 1916, and has been a publicly held company since 1969. Forest holds assets in several exploration and producing areas in the United States and has exploratory and development interests in two other countries. On June 1, 2011, Forest completed an initial public offering of approximately 18% of the common stock of its then wholly-owned subsidiary, Lone Pine Resources Inc. ("Lone Pine"), which held Forest's ownership interests in its Canadian operations. On September 30, 2011, Forest distributed, or spun-off, its remaining 82% ownership in Lone Pine to Forest's shareholders, by means of a special stock dividend of Lone Pine common shares. Unless the context indicates otherwise, the terms "Forest," the "Company," "we," "our," and "us," as used in this Quarterly Report on Form 10-Q, refer to Forest Oil Corporation and its subsidiaries.

Basis of Presentation

The Condensed Consolidated Financial Statements included herein are unaudited and include the accounts of Forest and its consolidated subsidiaries, all of which were wholly-owned during the periods presented. As a result of the spin-off, Lone Pine's results of operations are reported as discontinued operations in Forest's Condensed Consolidated Statement of Operations for the three months ended March 31, 2011. See Note 10 for more information regarding the results of operations of Lone Pine. In the opinion of management, all adjustments, which are of a normal recurring nature, have been made that are necessary for a fair presentation of the financial position of Forest at March 31, 2012, and the results of its operations, its comprehensive income, its cash flows, and changes in its shareholders' equity for the periods presented. Interim results are not necessarily indicative of expected annual results because of the impact of fluctuations in the price of oil, natural gas, and natural gas liquids and the impact the prices have on our revenues and fair values of our derivative instruments.

In the course of preparing the Condensed Consolidated Financial Statements, management makes various assumptions, judgments, and estimates to determine the reported amounts of assets, liabilities, revenues, and expenses, and in the disclosures of commitments and contingencies. Changes in these assumptions, judgments, and estimates will occur as a result of the passage of time, and the occurrence of future events and, accordingly, actual results could differ from amounts previously established.

The more significant areas requiring the use of assumptions, judgments, and estimates relate to volumes of oil, natural gas, and natural gas liquids reserves used in calculating depletion, the amount of future net revenues used in computing the ceiling test limitations, and the amount of future capital costs and abandonment obligations used in such calculations, determining impairments of investments in unproved properties, valuing deferred tax assets and goodwill, and estimating fair values of financial instruments, including derivative instruments.

Certain amounts in the prior year financial statements have been reclassified to conform to the 2012 financial statement presentation primarily due to presenting the results of operations of Lone Pine as discontinued operations.

For a more complete understanding of Forest's operations, financial position, and accounting policies, reference is made to the consolidated financial statements of Forest, and related notes thereto, filed with Forest's Annual Report on Form 10-K for the year ended December 31, 2011, previously filed with the Securities and Exchange Commission

(“SEC”).

(2) EARNINGS (LOSS) PER SHARE

Basic earnings (loss) per share is computed using the two-class method by dividing net earnings (loss) attributable to common stock by the weighted average number of common shares outstanding during each period. The two-class method of computing earnings (loss) per share is required to be used since Forest has participating securities. The two-class method is an earnings allocation formula that determines earnings (loss) per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Holders of restricted stock issued under Forest’s stock incentive plans have the right to receive non-forfeitable cash and certain non-cash dividends, participating on an equal basis with common stock. Holders of phantom stock units issued to directors under Forest’s stock incentive plans also have the right to receive non-forfeitable cash and certain non-cash dividends, participating on an equal

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basis with common stock, while phantom stock units issued to employees do not participate in dividends. Stock options issued under Forest's stock incentive plans do not participate in dividends. Performance units issued under Forest's stock incentive plans do not participate in dividends in their current form. Holders of performance units participate in dividends paid during the performance units' vesting period only after the performance units vest with common shares being earned by the holders of the performance units. Performance units may vest with no common shares being earned, depending on Forest's shareholder return over the performance units' vesting period in relation to the shareholder returns of specified peers. See Note 3 for more information on Forest's stock-based incentive awards. In summary, restricted stock issued to employees and directors and phantom stock units issued to directors are participating securities, and earnings are allocated to both common stock and these participating securities under the two-class method. However, these participating securities do not have a contractual obligation to share in Forest's losses. Therefore, in periods of net loss, none of the loss is allocated to these participating securities.

Under the treasury stock method, diluted earnings (loss) per share is computed by dividing (a) net earnings (loss), adjusted for the effects of certain contracts that provide the issuer or holder with a choice between settlement methods, by (b) the weighted average number of common shares outstanding, adjusted for the dilutive effect, if any, of potential common shares (e.g., stock options, unvested restricted stock grants, unvested phantom stock units that may be settled in shares, and unvested performance units). No potential common shares are included in the computation of any diluted per share amount when a net loss exists, as was the case for the three months ended March 31, 2012 and 2011.

The following reconciles net earnings (loss) as reported in the Condensed Consolidated Statements of Operations to net earnings (loss) used for calculating basic and diluted earnings (loss) per share for the periods presented.

	Three Months Ended March 31,					
	2012			2011		
	Continuing Operations	Discontinued Operations	Total	Continuing Operations	Discontinued Operations	Total
	(In Thousands)					
Net earnings (loss)	$(32,673)	$ —	$(32,673)	$(9,921)	$ 6,591	$(3,330)
Net earnings attributable to participating securities	—	—	—	—	—	—
Net earnings (loss) attributable to common stock for basic earnings per share	$(32,673)	$ —	$(32,673)	$(9,921)	$ 6,591	$(3,330)
Adjustment for liability classified stock-based compensation awards	—	—	—	—	—	—
Net earnings (loss) for diluted earnings per share	$(32,673)	$ —	$(32,673)	$(9,921)	$ 6,591	$(3,330)

The following reconciles basic weighted average common shares outstanding to diluted weighted average common shares outstanding for the periods presented.

	Three Months Ended March 31,	
	2012	2011
	(In Thousands)	
Weighted average common shares outstanding during the period for basic earnings (loss) per share	113,821	111,343
Dilutive effects of potential common shares	—	—
Weighted average common shares outstanding during the period, including the effects of dilutive potential common shares, for diluted earnings (loss) per share	113,821	111,343

(3) STOCK-BASED COMPENSATION

Equity Incentive Plans

Forest maintains the 2001 and 2007 Stock Incentive Plans (the “Plans”) under which qualified and non-qualified stock options, restricted stock, performance units, phantom stock units, and other awards may be granted to employees, consultants, and non-employee directors of Forest and its subsidiaries.

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Compensation Costs

The table below sets forth stock-based compensation of continuing operations for the three months ended March 31, 2012 and 2011, and the remaining unamortized amounts and weighted average amortization period as of March 31, 2012.

	Stock Options	Restricted Stock	Performance Units	Phantom Stock Units	Total[1][2]
	(In Thousands)				
Three months ended March 31, 2012:					
Total stock-based compensation costs	$—	$3,776	$ 1,212	$933	$5,921
Less: stock-based compensation costs capitalized	—	(1,708)	(390)	(499)	(2,597)
Stock-based compensation costs expensed	$—	$2,068	$ 822	$434	$3,324
Unamortized stock-based compensation costs	$—	$23,703	$ 13,197	$9,091 [3]	$45,991
Weighted average amortization period remaining	—	2.1 years	2.1 years	1.7 years	2.0 years
Three months ended March 31, 2011:					
Total stock-based compensation costs	$163	$6,369	$ 639	$588	$7,759
Less: stock-based compensation costs capitalized	(71)	(2,591)	(179)	(200)	(3,041)
Stock-based compensation costs expensed	$92	$3,778	$ 460	$388	$4,718

(1) The Company also maintains an employee stock purchase plan (which is not included in the table) under which $.1 million of compensation cost was recognized in each of the three-month periods ended March 31, 2012 and 2011. In addition to the compensation costs set forth in the table above, in June 2011 and March 2012 the Company granted cash-based long-term incentive awards under which a negligible amount of compensation cost was recognized during the three months ended March 31, 2012 due primarily to a reduction in Forest's common stock price, and under which $.5 million remains as unamortized stock-based compensation costs at March 31, 2012.

(2) The awards are comprised of time-based and performance-based components. Under the time-based component, a cash payment will be made three years after the date of grant dependent on the change in the market value of Forest's common stock during the three-year period, and under the performance-based component, a cash payment will be made three years after the date of grant dependent on the total shareholder return on Forest's common stock in comparison to that of a peer group during the three-year period.

(3) Based on the closing price of Forest's common stock on March 31, 2012.

Stock Options

The following table summarizes stock option activity in the Plans for the three months ended March 31, 2012.

	Number of Options	Weighted Average Exercise Price	Aggregate Intrinsic Value (In Thousands)[1]	Number of Options Exercisable
Outstanding at January 1, 2012	1,766,587	$ 14.55	$ 2,731	1,766,587
Granted	—	—		
Exercised	—	—	—	
Cancelled	(6,776)	17.29		
Outstanding at March 31, 2012	1,759,811	$ 14.54	$ 1,540	1,759,811

(1)

The intrinsic value of a stock option is the amount by which the market value of the underlying stock, as of the date outstanding or exercised, exceeds the exercise price of the option.

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Restricted Stock, Performance Units, and Phantom Stock Units

The following table summarizes the restricted stock, performance unit, and phantom stock unit activity in the Plans for the three months ended March 31, 2012.

	Restricted Stock			Performance Units			Phantom Stock Units		
	Number of Shares	Weighted Average Grant Date Fair Value	Vest Date Fair Value (In Thousands)	Number of Units[1]	Weighted Average Grant Date Fair Value	Vest Date Fair Value (In Thousands)	Number of Units[2]	Weighted Average Grant Date Fair Value	Vest Date Fair Value (In Thousands)
Unvested at January 1, 2012	2,474,112	$24.00		655,120	$19.50		1,238,817	$14.32	
Awarded	547,025	12.46		511,500	14.70		—	—	
Vested	(19,980)	23.71	$246	—	—	$—	(8,468)	15.71	$105
Forfeited	(18,735)	23.86		—	—		(3,995)	16.44	
Unvested at March 31, 2012	2,982,422	$21.89		1,166,620	$17.39		1,226,354	$14.30	

(1) Forest granted 511,500 performance units on March 12, 2012, with a grant date fair value of $14.70 each. Under the terms of the award agreements, each performance unit represents a contractual right to receive one share of Forest's common stock; provided that the actual number of shares that may be deliverable under an award will range from 0% to 200% of the number of performance units awarded, depending on Forest's relative total shareholder return in comparison to an identified peer group during the thirty-six-month performance period ending on February 28, 2015.

(2) Of the unvested phantom stock units at March 31, 2012, 6,080 units can be settled in cash, shares of common stock, or a combination of both, while the remaining 1,220,274 units can only be settled in cash. The phantom stock units have been accounted for as a liability within the Condensed Consolidated Financial Statements. All of the 8,468 phantom stock units that vested during the three months ended March 31, 2012 were settled in cash.

(4) DEBT

The components of debt are as follows:

	March 31, 2012			December 31, 2011		
	Principal	Unamortized Premium (Discount)	Total	Principal	Unamortized Premium (Discount)	Total
	(In Thousands)					
Credit Facility	$215,000	$—	$215,000	$105,000	$—	$105,000
7% Senior Subordinated Notes due 2013	12	—	12	12	—	12
8½% Senior Notes due 2014	600,000	(10,938)	589,062	600,000	(12,389)	587,611
7¼% Senior Notes due 2019	1,000,000	407	1,000,407	1,000,000	421	1,000,421
Total long-term debt	$1,815,012	$(10,531)	$1,804,481	$1,705,012	$(11,968)	$1,693,044

Bank Credit Facility

As of March 31, 2012, the Company had a $1.5 billion credit facility (the “Credit Facility”) with a syndicate of banks led by JPMorgan Chase Bank, N.A., which matures in June 2016. The size of the Credit Facility may be increased by $300 million, to a total of $1.8 billion, upon agreement between the applicable lenders and Forest.

Forest’s availability under the Credit Facility is governed by a borrowing base. As of March 31, 2012, the borrowing base under the Credit Facility was $1.25 billion. The determination of the borrowing base is made by the lenders in their sole discretion, on a semi-annual basis, taking into consideration the estimated value of Forest’s oil and gas properties based on pricing models determined by the lenders at such time, in accordance with the lenders’ customary practices for oil and gas loans. The available borrowing amount under the Credit Facility could increase or decrease based on such redetermination. In addition to the scheduled semi-annual redeterminations, Forest and the lenders each have discretion at any time, but not more often than once during a calendar year, to have the borrowing base redetermined. The borrowing base is also subject to automatic adjustments if certain events occur. A lowering of the borrowing base could require Forest to repay indebtedness in excess of the borrowing base in order to cover the deficiency. The borrowing base was reaffirmed at $1.25 billion in April 2012 and the next scheduled redetermination of the borrowing base will occur on or about November 1, 2012. The Credit

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Facility is collateralized by Forest's assets, and Forest is required to mortgage and grant a security interest in 75% of the present value of the estimated proved oil and gas properties and related assets of Forest and its U.S. subsidiaries.

At March 31, 2012, there were outstanding borrowings of $215.0 million under the Credit Facility at a weighted average interest rate of 1.8% and Forest had used the Credit Facility for $1.8 million in letters of credit, leaving an unused borrowing amount under the Credit Facility of $1.033 billion.

(5) PROPERTY AND EQUIPMENT

Full Cost Method of Accounting

The Company uses the full cost method of accounting for oil and gas properties. Separate cost centers are maintained for each country in which the Company has operations. During the periods presented, the Company’s primary oil and gas operations were conducted in the United States and Canada. Upon the spin-off of Lone Pine on September 30, 2011, the Company no longer has any operations in Canada. All costs incurred in the acquisition, exploration, and development of properties (including costs of surrendered and abandoned leaseholds, delay lease rentals, dry holes, and overhead related to exploration and development activities) and the fair value of estimated future costs of site restoration, dismantlement, and abandonment activities are capitalized. During the three months ended March 31, 2012 and 2011, Forest’s continuing operations capitalized $11.6 million and $12.1 million of general and administrative costs (including stock-based compensation), respectively. Interest costs related to significant unproved properties that are under development are also capitalized to oil and gas properties. During the three months ended March 31, 2012 and 2011, Forest’s continuing operations capitalized $2.2 million and $1.9 million, respectively, of interest costs attributed to unproved properties.

Investments in unproved properties, including capitalized interest costs, are not depleted pending determination of the existence of proved reserves. Unproved properties are assessed periodically to ascertain whether impairment has occurred. Unproved properties whose costs are individually significant are assessed individually by considering the primary lease terms of the properties, the holding period of the properties, geographic and geologic data obtained relating to the properties, and estimated discounted future net cash flows from the properties. Estimated discounted future net cash flows are based on discounted future net revenues associated with probable and possible reserves, risk adjusted as appropriate. Where it is not practicable to assess individually the amount of impairment of properties for which costs are not individually significant, such properties are grouped for purposes of assessing impairment. The amount of impairment assessed is added to the costs to be amortized, or is reported as a period expense, as appropriate.

Gain or loss is not recognized on the sale of oil and natural gas properties unless the sale significantly alters the relationship between capitalized costs and estimated proved oil and natural gas reserves attributable to a cost center.

Depletion of proved oil and gas properties is computed on the units-of-production method, whereby capitalized costs, as adjusted for future development costs and asset retirement obligations, are amortized over the total estimated proved reserves. The Company uses its quarter-end reserves estimates to calculate depletion for the current quarter.

The Company performs a ceiling test each quarter on a country-by-country basis under the full cost method of accounting. The ceiling test is a limitation on capitalized costs prescribed by SEC Regulation S-X Rule 4-10. The ceiling test is not a fair value based measurement. Rather, it is a standardized mathematical calculation. The ceiling test provides that capitalized costs less related accumulated depletion and deferred income taxes for each cost center may not exceed the sum of (1) the present value of future net revenue from estimated production of proved oil and gas reserves using current prices, excluding the future cash outflows associated with settling asset retirement obligations that have been accrued on the balance sheet, at a discount factor of 10%; plus (2) the cost of properties not being amortized, if any; plus (3) the lower of cost or estimated fair value of unproved properties included in the costs being amortized, if any; less (4) income tax effects related to differences in the book and tax basis of oil and gas properties. Should the net capitalized costs for a cost center exceed the sum of the components noted above, a ceiling test write-down would be recognized to the extent of the excess capitalized costs. If natural gas prices remain depressed in the U.S., Forest will likely be required to record a ceiling test write-down of its U.S. cost center in the near future.

In April 2012, an Italian regional regulatory body concluded its review of Forest's environmental impact assessment ("EIA") and denied approval. Approval of the EIA is necessary in order for Forest to commence production in Italy. Forest plans to appeal the region's denial. In the meantime, however, Forest has determined that it can no longer conclude with reasonable certainty that its Italian natural gas reserves are producible and, therefore, can no longer be classified as proved reserves. The Italian reserves are now classified as probable. Since Forest received the ruling prior to issuing its March 31, 2012 financial statements, Forest recorded a ceiling test write-down of its Italian cost center for the three months ended March

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31, 2012 of $34.8 million.

Acquisitions

In February 2012, the Company issued 2.7 million shares of common stock, valued at $36.4 million, pursuant to a lease purchase agreement whereby Forest acquired leases on unproved oil and natural gas properties in the Wolfbone oil play in the Permian Basin in Texas.

(6) INCOME TAXES

A reconciliation of reported income tax attributable to continuing operations to the amount of income tax that would result from applying the United States federal statutory income tax rate to pretax loss from continuing operations is as follows:

	Three Months Ended March 31,	
	2012	2011
	(In Thousands)	
Federal income tax at 35% of loss from continuing operations before income taxes	$(11,115)	$(5,003)
State income taxes, net of federal income tax benefits	(387)	(168)
Effect of federal, state, and foreign tax on permanent items	64	(246)
Valuation allowance on foreign deferred tax benefit of ceiling test write-down	12,606	—
Other	(253)	1,044
Total income tax	$915	$(4,373)

(7) FAIR VALUE MEASUREMENTS

The Company's assets and liabilities measured at fair value on a recurring basis at March 31, 2012 and December 31, 2011 are set forth in the table below.

	March 31, 2012	December 31, 2011
	Using Significant Other Observable Inputs (Level 2)(1)	
	(In Thousands)	
Assets:		
Derivative instruments(2):		
Commodity	$110,118	$79,487
Interest rate	19,422	20,556
Total assets	$129,540	$100,043
Liabilities:		
Derivative instruments(2):		
Commodity	$53,130	$28,944
Interest rate	—	—
Total liabilities		