

GEOPETRO RESOURCES CO
Form 10-K
March 30, 2012
[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Form 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2011

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 001-16749

GeoPetro Resources Company

(Exact name of registrant as specified in its charter)

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California
(State of incorporation)

94-3214487
(IRS Employer Identification Number)

150 California Street, Suite 600
San Francisco, CA
(Address of principal executive offices)

94111
(Zip Code)

(415) 398-8186

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, No Par Value	NYSE Amex US

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in 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) 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 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). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K 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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

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Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller Reporting Company

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

The aggregate market value of the registrant's common stock held by non-affiliates was approximately \$15,365,085 based on the closing sale price of \$0.41 per share as reported by NYSE Amex (formerly the American Stock Exchange) on June 30, 2011.

The number of shares of the registrant's common stock outstanding on March 30, 2012 was 45,253,101.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement relating to the 2012 Annual Meeting of Shareholders to be filed on or before April 30, 2012, are incorporated by reference into Part III of this Form 10K.

Table of Contents

CAUTIONARY STATEMENT CONCERNING FORWARD-LOOKING STATEMENTS

We are including the following discussion to inform our existing and potential security holders generally of some of the risks and uncertainties that can affect our company and to take advantage of the safe harbor protection for forward-looking statements that applicable federal securities law affords.

From time to time, our management or persons acting on our behalf may make forward-looking statements to inform existing and potential security holders about our company. All statements other than statements of historical facts included in this report regarding our financial position, business strategy, plans and objectives of management for future operations, industry conditions, and indebtedness covenant compliance are forward-looking statements. When used in this report, forward-looking statements are generally accompanied by terms or phrases such as estimate, project, predict, believe, expect, anticipate, target, plan, intend, seek, goal, will, should, or may, which are expressions that convey the uncertainty of future events or outcomes. Items contemplating or making assumptions about actual or potential future sales, market size, collaborations, and trends or operating results also constitute such forward-looking statements.

Forward-looking statements involve inherent risks and uncertainties, and important factors (many of which are beyond our company's control) that could cause actual results to differ materially from those set forth in the forward-looking statements, including the following: general economic or industry conditions, nationally and/or in the communities in which our company conducts business, changes in the interest rate environment, legislation or regulatory requirements, geological, geophysical, and engineering uncertainties, conditions of the securities markets, our ability to raise capital, changes in accounting principles, policies or guidelines, financial or political instability, acts of war or terrorism, other economic, competitive, governmental, regulatory and technical factors affecting our company's operations, products, services and prices.

We have based these forward-looking statements on our current expectations and assumptions about future events. While our management considers these expectations and assumptions to be reasonable, they are inherently subject to significant business, economic, competitive, regulatory and other risks, contingencies and uncertainties, most of which are difficult to predict and many of which are beyond our control. Accordingly, results actually achieved may differ materially from expected results in these statements. Forward-looking statements speak only as of the date they are made. You should consider carefully the statements in Item 1A. Risk Factors and other sections of this report, which describe factors that could cause our actual results to differ from those set forth in the forward-looking statements. Our company does not undertake, and specifically disclaims, any obligation to update any forward-looking statements to reflect events or circumstances occurring after the date of such statements.

Readers are urged not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. We assume no obligation to update any forward-looking statements in order to reflect any event or circumstance that may arise after the date of this report, other than as may be required by applicable law or regulation. Readers are urged to carefully review and consider the various disclosures made by us in our reports filed with the United States Securities and Exchange Commission (SEC) which attempt to advise interested parties of the risks and factors that may affect our business, financial condition, results of operation and cash flows. If one or more of these risks or uncertainties materialize, or if the underlying assumptions prove incorrect, our actual results may vary materially from those expected or projected.

Table of Contents

GEOPETRO RESOURCES COMPANY

TABLE OF CONTENTS

	Page
<u>PART I</u>	
<u>Item 1.</u>	<u>Business</u> 4
<u>Item 1A.</u>	<u>Risk Factors</u> 9
<u>Item 1B.</u>	<u>Unresolved Staff Comments</u> 20
<u>Item 2.</u>	<u>Properties</u> 20
<u>Item 3.</u>	<u>Legal Proceedings</u> 29
<u>Item 4.</u>	<u>Mine Safety Disclosures</u> 29
<u>PART II</u>	
<u>Item 5.</u>	<u>Market for the Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities</u> 30
<u>Item 6.</u>	<u>Selected Consolidated Financial Data</u> 31
<u>Item 7.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> 32
<u>Item 7A.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u> 40
<u>Item 8.</u>	<u>Financial Statements and Supplementary Data</u> 40
<u>Item 9.</u>	<u>Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</u> 40
<u>Item 9A.</u>	<u>Controls and Procedures</u> 40
<u>Item 9B.</u>	<u>Other Information</u> 41
<u>PART III</u>	
<u>Item 10.</u>	<u>Directors, Executive Officers and Corporate Governance</u> 42
<u>Item 11.</u>	<u>Executive Compensation</u> 42
<u>Item 12.</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u> 42
<u>Item 13.</u>	<u>Certain Relationships and Related Transactions, and Director Independence</u> 42
<u>Item 14.</u>	<u>Principal Accountant Fees and Services</u> 42
<u>PART IV</u>	
<u>Item 15.</u>	<u>Exhibits and Financial Statement Schedules</u> 43
<u>Signatures</u>	44
<u>Glossary of Oil and Natural Gas Terms</u>	45
<u>Index to Consolidated Financial Statements</u>	F-1

Table of Contents

PART I

Item 1. Business

We were incorporated in the State of Wyoming in August 1994 under the name GeoPetro Company as an oil and gas exploration, development drilling and production company. In June 1996, we merged with our wholly-owned subsidiary, GeoPetro Resources Subsidiary Company, a California corporation, and the resulting merged company is incorporated in the state of California under the California General Corporation Law under the name GeoPetro Resources Company (GeoPetro). Our principal and registered office is located at 150 California Street, Suite 600, San Francisco, California, USA 94111. We maintain a website located at www.geopetro.com.

Inter-Corporate Relationships

We hold 100% of the shares of Redwood Energy Company (Redwood), a Texas corporation. Redwood is the general partner of, and holds a 5% interest in, Redwood Energy Production, L.P. (Redwood LP), a Texas limited partnership. We are the sole limited partner of Redwood LP and own the remaining 95% partnership interest in Redwood LP. Redwood also holds a 100% interest in Madisonville Midstream LLC (Madisonville Midstream), a Texas limited liability company.

We hold a 100% interest in GeoPetro Alaska LLC (GeoPetro Alaska), an Alaska limited liability company; a 100% interest in GeoPetro Pacific LLC (GeoPetro Pacific), a Delaware limited liability company; and a 100% interest in South Texas GeoPetro, LLC (South Texas GeoPetro), a Texas limited liability company.

We also hold 100% of the shares of GeoPetro Canada Ltd. (GeoPetro Canada), an Alberta corporation; and 100% of the shares of GeoPetro International Ltd., a British Virgin Islands company.

In addition, we hold a 12% interest in Continental-GeoPetro (Bengara II) Ltd. (C-G Bengara), a British Virgin Islands company; and held a 50% interest in CG Xploration Inc. (CG Xploration), a Delaware corporation, which was dissolved in December 2011.

General Development of the Business

During the past two years, we have conducted leasehold acquisition, exploration and drilling activities on our North American and Indonesian prospects. These projects currently encompass approximately 249,042 gross (35,126 net) acres, consisting of mineral leases, production sharing contracts and exploration permits that give us the right to explore for, develop and produce oil and natural gas. Most of these properties are in the exploration, appraisal or development drilling phase and have not begun to produce revenue from the sale of oil and natural gas.

In December 2000, we acquired working interests in oil and natural gas leases in the Madisonville Field in Madison County, Texas, including interests in the Rodessa Formation. Also included in the acquisition was the Magness Well, an existing well that had been drilled, cased and production tested in the Rodessa Formation. In October 2001, we re-completed and tested the Magness Well. In October 2002, we drilled, completed and successfully tested an injection well to dispose of waste products resulting from the treating process for gas produced from the Rodessa Formation. The Madisonville Field gas treatment plant and associated pipelines, which were built specifically for this project, were placed into service in May 2003, and the Magness Well began production in late May 2003. The first development well in the Madisonville Field, the Fannin Well, was drilled in 2005. In 2006, we drilled the Wilson and Mitchell wells. Presently, the Fannin and Magness wells are producing, while the Mitchell and Wilson wells are shut-in awaiting workovers. We own a 100% working interest in the four wells. Since 2003, substantially all of our revenue has been generated from natural gas sales derived from the Madisonville Field, and the Madisonville Project was our primary source of revenue in 2011. On December 31, 2008, GeoPetro acquired the gas treatment plant, as well as the related gas gathering pipelines and facilities. This acquisition has allowed the Company to improve operating efficiencies by consolidating the upstream and midstream portions of the Madisonville project. By owning the midstream portion of the Madisonville project, we not only expect better net price realizations and operational efficiencies (i.e. improved volume realizations), but we also control the timing and design of the expansion of the plant facilities as well as future expansions, if needed. Historically, our wells have been production constrained by the gas treatment plant at the Madisonville Field, which has a design treating capacity limit of approximately 18 MMcf/d. See [Properties Description of the Properties Texas The Madisonville Gas Treatment Plant and Gathering Facilities](#).

Table of Contents

Growth Strategy

Our growth strategy is to maximize shareholder value through the exploration and development drilling of oil and natural gas prospects. To carry out this philosophy we employ the following business strategies:

- identify and pursue potential projects which individually have the potential to be company makers which we define as projects which could generate a minimum unrisks net present value of \$50 million net to our interest using a 10% discount factor;
- perform geological, geophysical and engineering evaluations;
- gain control of key acreage;
- generate high quality drillable exploration and development drilling prospects;
- retain a large working interest in those projects which involve low risk development drilling, appraisal or exploration of proved, probable and possible reserves; and
- minimize early investment and exploration risk in higher risk exploratory prospects through farm-outs to other oil and natural gas companies and maintain meaningful interests with a carry through the exploration phase.

Risks Associated With Operations

Our business activities in Indonesia, Canada and the United States are subject to political and economic risks, including: loss of revenue, property and equipment as a result of unforeseen events like expropriation, nationalization, war, terrorist attacks and insurrection; risks of increases in import, export and transportation regulations and tariffs, taxes and governmental royalties; renegotiation of contracts with governmental entities; changes in laws and policies governing operations of foreign-based companies in Indonesia; exchange controls, and numerous other factors. While we expect these risks are greater in Indonesia, especially political risk, any one or more of such political or economic conditions could change in the United States or Canada to our detriment. For a related discussion of the risks attendant with our foreign operations, see Risk Factors.

Regulations

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Domestic exploration, production and sale of oil and gas are extensively regulated at both the federal and state levels. Our business is and will be directly or indirectly affected by numerous governmental laws and regulations applicable to the energy industry, including:

- Federal environmental laws and regulations
- State environmental laws and regulations
- Local environmental laws and regulations
- Federal energy laws and regulations
- Conservation laws and regulations
- Tax and other laws and regulations pertaining to the energy industry

Legislation, rules and regulations affecting the oil and gas industry are under constant review for amendment or expansion, frequently increasing the regulatory burden. Any changes in the existing legislation, rules or regulations could adversely affect our business. The regulatory burdens are often costly to comply with and carry substantial penalties for failure to comply.

Table of Contents

Our operations and activities are subject to numerous federal, state and local environmental laws and regulations. These laws and regulations:

- require the acquisition of permits;
- restrict the type, quantities and concentration of various substances that can be discharged into the environment;
- limit or prohibit drilling and other activities on wetlands and other designated, protected areas;
- regulate the generation, handling, storage, transportation, disposal and treatment of waste materials; and
- impose criminal or civil liabilities for pollution resulting from oil and natural gas operations

We expect that with increases in our exploratory and development drilling activities, the impact of environmental laws and regulations on our business and operations will also increase. We may be required in the future to make substantial outlays of money to comply with environmental laws and regulations. Additional changes in operating procedures and expenditures to comply with future environmental laws cannot be predicted.

Other than our U.S. projects, we do not operate the oil and gas properties in which we own an interest. In those instances, we are not in a position to exert direct control over compliance with most of the rules and regulations discussed above. We are substantially dependent on the operators of our non-operated oil and gas properties to monitor, administer and oversee such compliance. The failure of the operator to comply with such rules and regulations could result in substantial liabilities to us.

As the operator of the Madisonville Project, among other various environmental laws and regulations, we are subject to the U.S. Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and any comparable legislation adopted by Texas which imposes strict, joint and several liability on owners and operators of properties and on persons who dispose of or arrange for the disposal of hazardous substances found on or under the sites of such properties.

Under CERCLA, one owner, lessee or other party, having responsibility for and an interest in a site requiring cleanup may, under certain circumstances, be required to bear a disproportionate share of liability for the cost of such cleanup if payments cannot be obtained from other responsible parties. The Resource Conservation and Recovery Act (RCRA) and comparable rules adopted by Texas and other states regulate the generation, management and disposal of hazardous oil and gas waste.

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The Railroad Commission of Texas (RRC) has been delegated the responsibility and authority to regulate and prevent pollution from oil and gas operations, including the prevention of pollution of surface or subsurface water resulting from the drilling of oil and gas wells and the production of oil and gas. In addition to regulating the generation, management and disposal of hazardous oil and gas waste, the RRC has been delegated authority to regulate underground hydrocarbon storage, saltwater disposal pits and injection wells.

The drilling of oil and gas wells in Texas requires operators to obtain drilling permits, file an organization report, issue a performance bond or other form of financial security, such as a letter of credit, and obtain a permit to maintain pits to store and dispose of drilling fluids, saltwater and waste as well as other types of pits for other purposes. The issuance of such permits is conditioned upon the RRC 's determination that these pits will not result in waste or pollution of surface or subsurface water.

Other states in which we have an interest in oil and gas properties may impose similar or more stringent regulations than imposed under CERCLA or RCRA.

To date, we have re-completed an existing producing well and drilled three additional wells and an injection well in the Madisonville Project as operator. In addition, we may drill oil, gas and disposal wells in the future as the operator and will be required to obtain local government and other permits to drill such wells. There can be no assurance that such permits will be available on a timely basis or at all. Texas and other states have statutes or regulations pertaining to conservation matters which, among other matters, regulate the unitization or pooling of gas properties and the spacing, plugging and abandonment of such wells and set limits on the maximum rates of natural gas that can be produced from gas wells.

Table of Contents

In re-completing the existing well on the Madisonville Project, we were required to drill a well for injection or disposal of produced waste gas from the wells. Injection wells are subject to regulation under the Safe Drinking Water Act (SDWA) and the regulations and procedures which have been adopted by the Environmental Protection Agency (EPA) under that Act. Generally, enforcement procedures under the SDWA are administered by the EPA unless such authority has been delegated by the EPA to a state which has primary enforcement responsibility based on the EPA s determination that the state has adopted drinking water regulations no less stringent than the national primary drinking water regulations and meets certain other criteria. Underground injection wells not used for the underground injection of natural gas for storage are generally unlawful and subject to penalties under the SWDA unless authorized by:

- permit issued by the EPA or a state having primary enforcement responsibility, or
- rule pursuant to an underground injection control program established by a state or the EPA.

To the extent our pipelines transport natural gas in interstate commerce, the rates, terms and conditions of that transportation service are subject to regulation by the Federal Energy Regulatory Commission (FERC), pursuant to Section 311 of the Natural Gas Policy Act of 1978 (NGPA), which regulates, among other things, the provision of transportation services by an intrastate natural gas pipeline on behalf of an interstate natural gas pipeline. Under the Energy Policy Act of 2005, the FERC has authority to impose penalties for violations of the Natural Gas Act, up to \$1 million per day for each violation and disgorgement of profits associated with any violation.

The regulatory burden on the oil and natural gas industry increases our cost of doing business. Future developments, such as stricter requirements of environmental or health and safety laws and regulations affecting our business or more stringent interpretations of, or enforcement policies with respect to, such laws and regulations, could adversely affect us. To meet changing permitting and operational standards, we may be required, over time, to make site or operational modifications at our facilities, some of which might be significant and could involve substantial capital expenditures. There can be no assurance that material costs or liabilities will not arise from these or additional environmental matters that may be discovered or otherwise may arise from future requirements of law. See Risk Factors Risks Related to Our Business

Foreign Regulations

We own 12% of C-G Bengara which in turn owns an interest in an oil and gas project located in Indonesia. We have farmed out our interest in this project to a third party who is the operator of this project. In the exploration, drilling and development of the property, this operator will be required to comply with the environmental, conservation, tax and other laws and regulations in Indonesia. We also own non-operated working interests in oil and gas projects located in Canada. In the exploration, drilling and development of these properties, those operators will be required to comply with the environmental, conservation, tax and other laws and regulations in Canada.

Technology

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We participate in projects utilizing economically feasible exploration technology in our exploration and development drilling activities to reduce risks, lower costs, and more efficiently produce oil and gas. We believe that the availability of cost effective 2-D and 3-D seismic data makes its use in exploration and development drilling activities attractive from a risk management perspective in certain areas.

Briefly, through the use of a seismograph, a seismic survey sends pulses of sound from the surface down into the earth, and records the echoes reflected back to the surface. By calculating the speed at which sound travels through the various layers of rock, it is possible to estimate the depth to the reflecting surface. It then becomes possible to infer the structure of rock deep below the earth's surface. We evaluate substantially all of our exploratory prospects using 2-D seismic data. In addition, we own a license as to approximately 12 square miles of 3-D seismic data covering our leasehold and adjacent lands in the Madisonville Project.

The use of seismic technology does not entirely remove the risk of exploration and development drilling of oil and natural gas deposits. It is important to consider the following:

- we may not recognize significant geological features due to errors in interpretation, processing limitations, the presence of certain geological environments that are out of our control or other factors;
- seismic generally becomes less reliable with increasing depth of the geological horizon; and
- the use of this technology may increase our finding cost.

Table of Contents

Principal Products

Our principal product is natural gas produced from properties in which we own an interest. Since our inception, we have realized only limited production of natural gas from the properties in which we own an interest. We also have working interests in various undeveloped oil and gas properties. See [Properties](#) for a general description of these properties.

During the last two fiscal years, 100% of our revenues have been derived from the sale of natural gas. Substantially all of our natural gas sales have been generated by three producing wells located in the Madisonville Field in East Texas. Natural gas produced by the wells is delivered via a gathering pipeline to a nearby gas treatment plant where the gas is treated to remove impurities. From the plant, the natural gas is transported approximately nine miles to one of two common carrier pipelines. This delivery point is where all natural gas sales occur. The price received for the natural gas is the Houston Ship Channel price index less certain adjustments for the quality of the gas delivered.

Reserves

The volume of production from oil and natural gas properties generally declines as reserves are depleted, with the rate of decline depending on reservoir characteristics. Our proved reserves will decline as reserves are produced from our properties unless we are able to acquire or develop new reserves.

Acquisition of Producing Properties

We may supplement our exploration efforts with acquisitions of producing oil and gas properties. We may seek to acquire producing properties that are underperforming relative to their potential.

Patents, Trademarks, Licenses, Franchises and Concessions Held

Permits and licenses are important to our operations, since they allow the search for and the extraction of any oil, gas and minerals discovered on the areas covered. Provided a commercial discovery is established thereon, the Bengara II PSC in Indonesia grants C-G Bengara the right to produce oil and gas from the contract area until 2027. See [Properties](#) for a general description of the permits and licenses under which we operate.

Seasonality of Business

Our business is not seasonal.

Working Capital Items

The majority of our current assets are in the form of cash received from the sale of natural gas from our Madisonville Project in Texas, amounts received from the sale of common and preferred stock in private placements, cash received from the issuance of debt instruments and cash received from the disposition of our interests in oil and gas properties. We use this cash to pay for the cost of our operations, service of debt facilities, and other administrative activities. For further information see Management's Discussion and Analysis of Financial Condition and Results of Operations.

Customers

Substantially all of our revenues are derived from sales to two customers, Luminant Energy Company, LLC and ETC Katy Pipeline, Ltd., of natural gas produced from our Madisonville Project in Texas. We contract to sell the gas with spot-market based contracts that vary with market forces. We have not committed any forward sales of our natural gas. During 2011 all of our revenue was derived from one customer. The loss of this customer could result in the loss of our revenues, which would have a material adverse effect on our results of operations. See Risk Factors .

Table of Contents

Competition

The oil and natural gas industry is intensely competitive and speculative in all of its phases. We encounter competition from other oil and natural gas companies in all areas of our operations. In seeking suitable oil and natural gas properties for acquisition, we compete with other companies operating in our areas of interest, including large oil and natural gas companies and other independent operators, which have greater financial resources and in many instances, have been engaged in the exploration and production business for a much longer time than we have. Many of our competitors also have substantially larger operating staffs than we do. Many of these competitors not only explore for and produce oil and natural gas but also market oil and natural gas and other products on a regional, national or worldwide basis. These competitors may be able to pay more for productive oil and natural gas properties and exploratory prospects and define, evaluate, bid for and purchase a greater number of properties and prospects than us. In addition, these competitors may have a greater ability to continue exploration activities during periods of low market prices. Our ability to acquire additional properties and to discover reserves in the future will depend on our ability to evaluate and select suitable properties and to consummate transactions in a highly competitive environment.

The prices of our natural gas production are controlled by market forces. However, competition in the oil and natural gas exploration industry also exists in the form of competition to acquire leases and obtain favorable transportation prices. Our Company is relatively small and may have difficulty acquiring additional acreage and/or projects and may have difficulty arranging for the transportation of our production. We also face competition in obtaining oil and natural gas drilling rigs and in sourcing the manpower to run them and provide related services.

Employees

We have 14 employees. We use the services of independent consultants and contractors to perform various professional services, including geologic, geophysical, petroleum, reservoir & drilling engineering, land, legal, environmental and tax services. On those properties where we are not the operator, we rely on outside operators to drill, produce and market our oil and natural gas.

Available Information

We maintain a website located at <http://www.geopetro.com> and electronic copies of our annual, quarterly and current reports, and any amendments to those reports, as well as our code of ethics, are available free of charge under the Investor Relations link on our website. This information is available on our website, as soon as practicable after such material is filed with, or furnished to, the SEC.

Item 1A. Risk Factors

In addition to risks and uncertainties in the ordinary course of business that are common to all businesses, important factors that are specific to our industry and our company could materially impact our future performance and results of operations. We have provided below a list of these risk factors that should be reviewed when considering our securities. These are not all the risks we face and other factors currently considered immaterial or unknown to us may impact our future operations.

Risks Related to Our Business

As of December 31, 2011, we have gross capitalized costs totaling \$65.4 million as proved and unproved oil and gas properties and gas processing plant whereas we have generated revenues of only \$44.1 million since January 1, 2003 and revenues of only \$1.0 million during the fiscal year ended December 31, 2011.

Since inception, our activities have been primarily related to acquiring and exploring leasehold interests in oil and natural gas properties in Texas, California, Alaska, Canada, Indonesia and Australia. We have incurred substantial acquisition and exploration costs and overhead expenses in our operations, and until 2003, excluding minor interest and dividend income, our only significant cash inflows were the recovery of capital invested in projects through sale or other divestitures of interests in oil and gas prospects to industry partners. As a result, we have sustained an accumulated deficit through December 31, 2011 of \$45.5 million. Our production activities commenced in May 2003. Since May 2003, over 98% of our revenue has been generated from natural gas sales derived from wells in the Madisonville Field in Texas. It is possible that in the future we will be unable to continue to generate revenues from our sales of natural gas from our Madisonville Field wells because our proved reserves decline as reserves are produced from the wells. The drilling of exploratory oil and natural gas wells is highly speculative and often unproductive. Our participation in future drilling activities to explore, develop and exploit the properties in which we have an interest, or in which we may acquire interests, may be unsuccessful, may fail to generate positive cash flow, and may not enable us to maintain profitability in the future.

Table of Contents

We may be unable to successfully expand the capacity of the Madisonville Gas Treatment Plant.

We own and operate, through Madisonville Midstream, gathering pipelines and a dedicated natural gas treatment plant (which we refer to as the Madisonville Gas Treatment Plant), to treat impurities in the natural gas generated by our Madisonville Project. We plan to expand the Madisonville Gas Treatment Plant's treatment capacity from 18 MMcf/d to 30 MMcf/d. There can be no assurance that we will be able to accomplish the expansion and achieve a full treatment capacity of 30 MMcf/d.

Even if we are able to successfully complete the expansion of the Madisonville Gas Treatment Plant from 18 MMcf/d to 30 MMcf/d, third parties may seek access to the plant through regulatory proceedings, which could limit our use of the Plant and disrupt our production operations.

Third parties have, and may in the future, seek access to the Madisonville Gas Treatment Plant through regulatory proceedings, which could restrict our access to the Plant, disrupt our production operations and negatively impact our revenues. An example of such a proceeding is the complaint that was filed by Crimson Exploration Inc. (Crimson) with the Railroad Commission of Texas in 2006 described under Properties Description of the Properties Texas The Madisonville Gas Treatment Plant and Gathering Facilities.

Substantially all of our revenues have been generated from natural gas sales derived from wells in the Madisonville Field, and 100% of our natural gas generated from the wells in the Madisonville Field is treated at the Madisonville Gas Treatment Plant. If our ability to treat natural gas at the Madisonville Gas Treatment Plant is limited for any reason, including but not limited to increased demands by third parties, our revenues may be adversely affected.

All of our current revenues are generated by our interest in the Madisonville Project. Delays or interruptions of the Madisonville Project natural gas drilling and production operations including, but not limited to, events beyond our control or the failure of third parties on which we rely to provide key services, could negatively impact our revenues.

All of our natural gas revenues for 2011 were derived from the Madisonville Project. In connection with that project, we have contracted with Gateway-Madisonville Pipeline, LLC (Gateway) which operates a sales pipeline for natural gas.

The failure of Gateway to perform its contractual obligations to us could impose delays or interruptions in our production operations and prevent us from generating revenues. In addition, events which are beyond our control, or that of Gateway, could affect our production operations. Such events include, but are not limited to:

- events referred to as force majeure, such as an act of God, act of a public enemy, war, blockade, public riot, lightning, fire, storm, flood, explosion and any other causes whether of the kind enumerated or otherwise not reasonably within the control of Gateway;

- the inability to secure raw materials or equipment;
- transportation accidents; and
- labor disputes and equipment failures.

We do not own all of the land on which our pipelines and facilities are located, and we are therefore subject to the possibility of not being able to retain necessary land use and associated increased costs.

We have the right to operate our pipelines on land owned by third parties for specified periods of time. Our loss of these rights, through our inability to renew rights-of-way contracts, leases or otherwise, could result in the suspension of our operations, or increased costs related to continuing operations elsewhere, which would have a material adverse effect on our business, results of operations and financial condition.

If third-party pipelines and other facilities interconnected to our natural gas pipelines and processing facilities become partially or fully unavailable to transport natural gas, our revenues could be adversely affected.

We depend upon third party pipelines and other facilities to provide delivery options from the Madisonville Gas Treatment Plant to our customers. If any of these third party pipelines become unavailable to transport the natural gas produced at the Plant, or if the gas quality specifications for these pipelines or facilities change, we would be required to find alternate means to transport our natural gas out of the Plant, which could increase our costs, reduce the revenues we might obtain from the sale of our natural gas or reduce our ability to process natural gas at the Plant.

Table of Contents

100% of our revenue in 2011 was derived from sales to a single customer. The loss of this customer could have a material adverse impact on our oil and gas revenues.

100% of our natural gas sales and revenue for the year ended December 31, 2011 were derived from the Madisonville Project, and 100% of our revenue was derived from sales to one customer, Luminant Energy Company, LLC. The loss of this customer could impact the price we receive for our gas sold due to lessened competition. The loss of, or material nonpayment by the customer could result in a loss of revenue. Our customer may be subject to their own operating risks which could increase the risk that they could default on their obligation to us.

Unless we replace our oil and natural gas reserves, our reserves and production will decline.

The volume of production from oil and natural gas properties generally declines as reserves are depleted, with the rate of decline depending on reservoir characteristics. Our proved reserves will decline as reserves are produced from our properties unless we are able to acquire or develop new reserves. The business of exploring for, developing or acquiring reserves is capital intensive. For example, as of December 31, 2011 we have capitalized costs of \$65.4 million as proved and unproved oil and gas properties and gas processing plant. To the extent cash flow from operations is reduced and external sources of capital become limited or unavailable, our ability to make the necessary capital investment to maintain or expand our asset base of oil and natural gas reserves will be impaired. Even if we are able to raise capital to develop or acquire additional properties, no assurance can be given that our future exploration and development drilling activities will result in the discovery of any reserves.

Our exploration and development drilling activities may not be commercially successful. The drilling of exploratory oil and natural gas wells is expensive, highly speculative and often unproductive.

Exploration for oil and natural gas on unproven prospects is expensive, highly speculative and involves a high degree of risk, including the risk that no commercially productive oil or natural gas reservoirs will be encountered. Reserves are dependent on our ability to successfully complete drilling activity on proven prospects.

The cost of drilling, completing and operating wells is often uncertain, and drilling operations may be curtailed, delayed or cancelled as a result of a variety of factors, including:

- unexpected drilling conditions, pressure or irregularities in formations;
- subsurface conditions or formations encountered during the drilling of wells, whether natural or mechanical, including but not limited to blowout, igneous rock, salt, saltwater flow, loss of circulation, loss of hole, abnormal pressures, or any other impenetrable substance or adverse condition, which renders further drilling of a well impossible or impractical;

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- equipment failures or accidents, adverse weather conditions;
- compliance with governmental requirements; and
- shortages or delays in the availability of drilling rigs, the delivery of equipment, and availability of qualified manpower.

Our evaluations of the oil and gas prospects of our properties may be wrong.

With the exception of the Madisonville Project, the properties in which we have an interest are prospects in which the presence of oil and natural gas reserves in commercial quantities has not been established. Any decision to engage in exploratory drilling or other activities on any of these properties will be dependent in part on the evaluation of data compiled by petroleum engineers and geologists and obtained through geophysical testing and geological analysis.

Table of Contents

Reservoir engineering, geophysics and geology are not exact sciences and the results of studies and tests used to make such evaluations are somet