UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended **September 30, 2008**

OR

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

For the transition period from _____________ to _________________

Commission File No. **0-9120**

TXCO RESOURCES INC.
(Exact Name of Registrant as Specified in its Charter)

DELAWARE	**84-0793089**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer I.D. No.)

777 E. SONTERRA BLVD., SUITE 350 SAN ANTONIO, TEXAS 78258
(Address of principal executive offices)

Registrant's telephone number, including area code: **(210) 496-5300**

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 is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a 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 ☐ Smaller-reporting company ☐
(Do not check if a smaller reporting company)

Indicate by check mark if the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☑

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of November 7, 2008.

Common Stock $0.01 par value	**36,482,420**
(Class of Stock)	(Number of Shares)

For more information go to www.txco.com.
The information at www.txco.com is not incorporated into this report.

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

TXCO RESOURCES INC.
Consolidated Balance Sheets
(Unaudited)

($ in thousands)	**September 30, 2008**	December 31, 2007
Assets		
Current Assets		
Cash and equivalents	**$6,572**	$9,831
Accounts receivable, net	**40,947**	17,952
Federal income tax receivable	**4,974**	4,974
Prepaid expenses and other	**5,224**	2,989
Accrued derivative asset	**67**	-
Total Current Assets	**57,784**	35,746
Property and Equipment, net - successful efforts method of accounting for oil and gas properties	**404,813**	314,941
Other Assets		
Deferred financing fees	**3,205**	2,613
Other assets	**1,380**	1,307
Accrued derivative asset	**50**	-
Total Other Assets	**4,635**	3,920
Total Assets	**$467,232**	$354,607

See notes to consolidated financial statements

TXCO RESOURCES INC.
Consolidated Balance Sheets
(Unaudited)

($ in thousands)	**September 30, 2008**	December 31, 2007
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable and accrued liabilities	**$66,603**	$51,261
Undistributed revenue	**3,810**	2,401
Notes payable	**170**	399
Derivative settlements payable	**668**	475
Preferred dividends payable	**1,420**	397
Accrued derivative obligation	**4,934**	4,725
Total Current Liabilities	**77,605**	59,658
Long-Term Liabilities		
Long-term debt	**130,000**	100,000
Deferred income taxes	**19,651**	12,007
Accrued derivative obligation	**6,060**	3,993
Asset retirement obligation	**8,538**	4,233
Total Long-Term Liabilities	**164,249**	120,233
Commitments and Contingencies	**-**	-
Stockholders' Equity		
Preferred stock, authorized 10,000,000 shares; Series A & B, -0- shares issued and outstanding Series C, -0- and 55,000 shares issued and outstanding Series D, 68,909 and -0- shares issued and outstanding Series E, 20,000 and -0- shares issued and outstanding	**1**	1
Common stock, par value $.01 per share; authorized 100,000,000 shares; issued 35,589,246 and 34,269,038 shares, outstanding 35,422,393 and 34,150,619 shares	**356**	343
Additional paid-in capital	**212,056**	177,030
Retained earnings	**21,134**	3,561
Accumulated other comprehensive loss, net of tax	**(7,179)**	(5,754)
Less treasury stock, at cost, 166,853 and 118,419 shares	**(990)**	(465)
Total Stockholders' Equity	**225,378**	174,716
Total Liabilities and Stockholders' Equity	**$467,232**	$354,607

See notes to consolidated financial statements

TXCO RESOURCES INC.
Consolidated Statements Of Operations
(Unaudited)

(in thousands, except earnings per share data)	**Three Months Ended September 30, 2008**	Three Months Ended September 30, 2007
Revenues		
Oil and gas sales	**$37,243**	$25,012
Gas gathering operations	**4,373**	3,227
Other operating income	**67**	34
Total Revenues	**41,683**	28,273
Costs and Expenses		
Lease operations	**4,942**	3,137
Drilling operations	**105**	-
Production taxes	**1,983**	1,418
Exploration expenses	**276**	269
Impairment and abandonments	**485**	(1,092)
Gas gathering operations	**4,220**	3,432
Depreciation, depletion and amortization	**12,780**	11,632
General and administrative	**2,911**	3,110
Total Costs and Expenses	**27,702**	21,906
Income from Operations	**13,981**	6,367
Other Income (Expense)		
Interest expense	**(2,269)**	(3,227)
Interest income	**45**	135
Loss on sale of assets	**(782)**	-
Loan fee amortization	**(305)**	(175)
Total Other Income (Expense)	**(3,311)**	(3,267)
Income before income taxes	**10,670**	3,100
Income tax (benefit) expense -- current	**80**	(50)
deferred	**3,575**	771
Net Income	**7,015**	2,379
Preferred dividends	**1,420**	-
Net Income Available to Common Stockholders	**$5,595**	$2,379
Earnings Per Share		
Basic	**$0.16**	$0.07
Diluted	**$0.16**	$0.07

See notes to consolidated financial statements

TXCO RESOURCES INC.
Consolidated Statements Of Operations
(Unaudited)

(in thousands, except earnings per share data)	**Nine Months Ended September 30, 2008**	Nine Months Ended September 30, 2007
Revenues		
Oil and gas sales	**$109,147**	$52,873
Gas gathering operations	**11,950**	8,872
Other operating income	**1,614**	84
Total Revenues	**122,711**	61,829
Costs and Expenses		
Lease operations	**13,377**	10,035
Drilling operations	**1,111**	-
Production taxes	**5,845**	3,014
Exploration expenses	**1,486**	923
Impairment and abandonments	**1,119**	289
Gas gathering operations	**12,002**	9,670
Depreciation, depletion and amortization	**39,067**	25,217
General and administrative	**10,816**	7,996
Total Costs and Expenses	**84,823**	57,144
Income from Operations	**37,888**	4,685
Other Income (Expense)		
Interest expense	**(6,503)**	(6,367)
Interest income	**143**	238
Loss on sale of assets	**(782)**	-
Loan fee amortization	**(892)**	(344)
Total Other Income (Expense)	**(8,034)**	(6,473)
Income (loss) before income taxes	**29,854**	(1,788)
Income tax (benefit) expense -- current	**80**	(5,301)
deferred	**8,378**	4,340
Net Income (Loss)	**21,396**	(827)
Preferred dividends	**3,823**	-
Net Income (Loss) Available to Common Stockholders	**$17,573**	$(827)
Earnings (Loss) Per Share		
Basic	**$0.51**	$(0.02)
Diluted	**$0.50**	$(0.02)

See notes to consolidated financial statements

TXCO RESOURCES INC.
Consolidated Statements Of Cash Flows
(Unaudited)

(in thousands, except earnings per share data)	**Nine Months Ended September 30, 2008**	Nine Months Ended September 30, 2007
Operating Activities		
Net income (loss)	**$21,396**	$(827)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation, depletion and amortization	**39,959**	25,562
Impairment, abandonments and dry hole costs	**1,119**	743
Loss on sale of assets	**782**	-
Deferred tax expense	**8,378**	4,340
Excess tax benefits from stock-based compensation	**(1,453)**	-
Non-cash compensation expense	**2,713**	1,184
Non-cash change in components of Other Comprehensive Income	-	1,524
Changes in operating assets and liabilities:		
Receivables	**(22,995)**	(8,160)
Prepaid expenses and other	**(3,791)**	(7,714)
Accounts payable and accrued expenses	**16,882**	15,431
Current income taxes payable (receivable)	**63**	(4,747)
Net cash provided by operating activities	**63,053**	27,336
Investing Activities		
Development and purchases of oil and gas properties	**(126,066)**	(68,141)
Purchase of other equipment	**(4,978)**	(2,317)
Purchase of subsidiary	-	(95,994)
Proceeds from sale of assets	**8,393**	-
Net cash used by investing activities	**(122,651)**	(166,452)
Financing Activities		
Proceeds from bank credit facility	**51,700**	164,750
Payments on bank credit facility	**(21,700)**	(22,851)
Proceeds from installment and other obligations	**190**	341
Payments on installment and other obligations	**(419)**	(418)
Issuance of preferred stock, net of expenses	**32,233**	429
Purchase of lower call option	**(11,617)**	-
Proceeds from sale of upper call option	**9,356**	-
Payment of preferred stock dividends	**(2,801)**	-
Cost of shares retired upon option exercises	**(2,414)**	-
Excess tax benefits from stock-based compensation	**1,453**	-
Proceeds from exercise of stock options	**850**	-
Proceeds from issuance of common stock, net of expenses	**33**	-
Purchase of treasury shares	**(525)**	(219)
Net cash provided by financing activities	**56,339**	142,032
Change in Cash and Equivalents	**(3,259)**	2,916
Cash and equivalents at beginning of period	**9,831**	3,882
Cash and Equivalents at End of Period	**$6,572**	$6,798

See notes to consolidated financial statements

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of TXCO Resources Inc. ("TXCO" or "the Company") have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. The accounting policies followed by the Company are set forth in Note A to the audited consolidated financial statements contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Certain reclassifications have been made to the prior period to conform to current presentation. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

2. Stock-based Compensation

The Company has stock-based employee compensation plans that are described more fully in Note F, "Stockholders' Equity," to the audited consolidated financial statements contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2007. Total stock-based compensation expense recognized was $2.7 million and $1.2 million, in the first nine months of 2008 and 2007, respectively.

Stock Options: In prior years, the Company issued stock options as compensation to employees and non-employee directors under its 1995 Flexible Incentive Plan. Generally, these options had a 10-year life and vested over two years for employees and three years for directors. Upon exercise, newly issued shares are utilized to fulfill the obligation. No options have been granted since 2004.

As of September 30, 2008, the Company had outstanding exercisable options to purchase 307,250 shares of common stock at prices ranging from $2.125 to $5.00 per share. The options expire at various dates through September 2014.

Stock Option Activity:	**Number Outstanding**	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Term**	**Aggregate Intrinsic Value**
1995 Flexible Incentive Plan:*	*(in thousands)*		*(in years)*	*(in thousands)*
Outstanding at December 31, 2007	713	$2.94	2.39	$8,596
Exercised	406	2.14		
Outstanding and exercisable at September 30, 2008	307	$3.99	4.28	$1,858

* There have been no options awarded under the 2005 Stock Incentive Plan.

***Restricted Stock*:** Beginning in 2006, the Company made annual restricted stock grants as compensation to employees and non-employee directors under its 2005 Stock Incentive Plan. During 2008, shares with an aggregate fair value of $1.5 million were granted to non-employee directors, net of forfeitures related to the Settlement Agreement with Third Point, LLC and certain other parties. For additional details on the Settlement Agreement, see the Form 8-K filed with the SEC on March 19, 2008. The vesting term for continuing directors is one year, while shares awarded to new directors vest over three years. Also as part of this Settlement Agreement, the vesting of 41,666 shares held by two exiting directors was accelerated. Additionally during 2008, shares with an aggregate fair value of $3.1 million and a three-year vesting period were granted to employees ($1.0 million aggregate fair value per year). The fair value is recognized as stock compensation expense (included in general and administrative expense on the Consolidated Statements of Operations) over the vesting periods.

2. Stock-based Compensation - continued

Restricted Stock Activity:	**Shares**
2005 Stock Incentive Plan:	*(in thousands)*
Unvested restricted stock at December 31, 2007	527
Granted	412
Vested	(260)
Forfeited	(36)
Unvested restricted stock at September 30, 2008	643

Warrants: At September 30, 2008, the Company had no outstanding warrants. In second quarter 2008, warrants to purchase 704,200 shares of common stock at $4.25 were exercised on a cashless basis, resulting in the issuance of 442,458 shares of common stock. The remaining warrants, to purchase 4,000 shares, expired in May 2008.

3. Earnings Per Share

The following is a reconciliation of the numerator and denominator of the basic and diluted earnings per share ("EPS") computation:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
(in thousands, except per share data)	**2008**	**2007**	**2008**	**2007**
Net income (loss)	$7,015	$2,379	$21,396	$(827)
Less: Preferred dividends	1,420	-	3,823	-
Income (loss) for basic earnings per share	5,595	2,379	17,573	(827)
Add: Income impact of any assumed conversions	-	-	-	-
Income (loss) for diluted earnings per share	$5,595	$2,379	$17,573	$(827)
Weighted-average number of common shares:				
Basic	34,780	33,578	34,413	33,355
Effect of dilutive securities:				
Stock options and warrants	130	782	387	-*
Restricted shares	643	546	646	-*
Convertible preferred stock	-	-	-	-
Diluted	35,553	34,906	35,446	33,355
Earnings per common share:				
Basic	$0.16	$0.07	$0.51	$(0.02)
Diluted	$0.16	$0.07	$0.50	$(0.02)

* Not applicable due to net loss for the period.

For the quarter ended September 30, 2008, the calculation of weighted-average number of common shares for diluted EPS does not include 4,758,909 and 1,152,074 of potential common shares derived from Series D and Series E convertible preferred stock, respectively, and 5,910,998 potential common shares derived from written call options, respectively, because their effect would have been anti-dilutive. The impact for the year-to-date period would have been 5,343,887 and 5,337,585, respectively.

If there had not been a net loss for the nine-months ended September 30, 2007, potential common shares would have been 906,173 and 396,052 from outstanding stock options and warrants, and non-vested shares, respectively. No outstanding stock options or warrants were anti-dilutive based on exercise price during the periods presented. No convertible securities were outstanding during the prior year periods.

3. Earnings Per Share - continued

When shares of TXCO's Series D and/or Series E Convertible Preferred Stock are converted into common shares, the Company may exercise its purchased call options with respect to the same number of common shares if the market price for TXCO common stock exceeds the option price.

Subsequent to the end of the quarter, holders of 12,000 shares of TXCO's Series D Convertible preferred stock, with an aggregate stated value of $12.0 million, converted those shares and received approximately 1,060,000 shares of TXCO's common stock. See the "Subsequent Event" section in Note 10. The Company did not exercise its purchased call options since the current market price was below the option price.

4. Income Taxes

In June 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes -- an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainly in income taxes recognized in financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 prescribes how a company should recognize, measure, present and disclose uncertain tax positions that the company has taken or expects to take in its income tax returns. FIN 48 requires that only income tax benefits meeting the "more likely than not" recognition threshold be recognized or continue to be recognized on its effective date. As required, the Company has adopted the provisions of FIN 48 effective January 1, 2007.

The Company has not included any accruals for unrecognized income tax benefits in its income tax calculation as of September 30, 2008 and September 30, 2007. The Company does not anticipate a significant change in its unrecognized tax benefits in the next 12 months.

As of September 30, 2008, the tax years ended December 31, 2003, through 2007 remained subject to examination by tax authorities.

The Company's effective tax rate was 34.3% and 28.3% for the three- and nine-month periods ended September 30, 2008, respectively. The Company's effective tax rate for the nine-month period was not proportional to that which would be expected for income before tax due to the exercise of stock options in first quarter 2008 with substantially lower option price than the current market price. These exercises resulted in a tax deduction to the Company of $4,275,000.

5. Derivative Instruments and Hedging Activity

Due to the volatility of oil and natural gas prices and interest rates, the Company, from time to time, enters into risk management transactions (e.g., swaps, collars and floors) for a portion of its oil and natural gas production and/or interest payments on its long-term debt. This allows it to achieve a more predictable cash flow, as well as to reduce exposure from price fluctuations. On a quarterly basis, the Company's management sets all of the Company's risk management policies, including quantity, types of instruments and counterparties. None of these instruments are used for trading purposes.

All of these price-risk management transactions are considered derivative instruments and accounted for in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"). These derivative instruments are intended to hedge the Company's price risk and could be considered hedges for economic purposes, but certain of these transactions may or may not qualify for hedge accounting. All derivative instrument contracts are recorded on the Consolidated Balance Sheets at fair value. The change in fair value for the effective portion of contracts designated as cash flow hedges is reflected in Other Comprehensive Income (Loss) in the Stockholders' Equity section of the Consolidated Balance Sheets. The realized gain or loss on derivative contracts is reported on the Consolidated Statement of Operations as the hedged transactions occur. The hedges are highly effective, and therefore, no hedge ineffectiveness has been recorded.

5. Derivative Instruments and Hedging Activity - continued

Commodity Price Risk-Related Hedging Activities: The Company had cash flow hedges in place during the periods shown, in accordance with the terms of our term loan and revolving credit facilities. The Company generally uses costless collars, based upon the same price indexes that are used for the majority of TXCO's commodity sales contracts, for hedging commodity price risk for approximately 50% of anticipated sales volumes. When commodity derivatives are used, they apply to only a portion of the Company's production, provide only partial price protection against declines in oil and natural gas prices, and partially limit the Company's potential gains from future increases in prices.

The following table reflects the realized losses from derivatives included in "Oil and gas sales" on the Consolidated Statements of Operations:

(in thousands)	**2008**	**2007**
For the three months ended September 30:		
Crude oil derivative realized settlement losses	$2,888	$111
Natural gas derivative realized settlement losses (gains)	254	(127)
Loss (gain) on commodity derivative contracts	$3,142	$(16)
For the nine months ended September 30:		
Crude oil derivative realized settlement losses	$7,682	$268
Natural gas derivative realized settlement losses	454	1,397
Loss on commodity derivative contracts	$8,136	$1,665

The fair value of outstanding commodity derivative contracts reflected on the balance sheet was as follows:

Trans-action Date	Trans-action Type	Beginning	Ending	Average Floor Price Per Unit	Average Ceiling Price Per Unit	Volumes Per Month	Fair Value of Outstanding Derivative Contracts *(1)* as of Sept. 30, 2008	Sept. 30, 2007
Crude Oil - Bbl (2):								
08/07-12/07	Collars	09/01/2007	12/31/2007	$65.00	$75.92	30,000	$-	$(596)
08/07-08/08	Collars	01/01/2008	12/31/2008	$75.35	$97.09	35,500	(2,205)	(1,175)
08/07-08/08	Collars	01/01/2009	12/31/2009	$71.40	$87.41	20,700	(5,455)	(596)
08/07-08/08	Collars	01/01/2010	06/30/2010	$68.33	$80.77	15,000	(2,426)	(168)
12/07-04/08	Collars	07/01/2010	12/31/2010	$75.80	$100.35	13,200	(1,124)	-
04/08	Collars	01/01/2011	06/30/2011	$90.00	$122.80	11,500	(121)	-
Natural Gas - mmBtu (3):								
08/07-12/07	Collars	09/01/2007	12/31/2007	$6.50	$6.84	100,000	-	67
08/07-08/08	Collars	01/01/2008	12/31/2008	$6.61	$10.45	105,500	61	58
08/07-08/08	Collars	01/01/2009	12/31/2009	$6.60	$11.64	86,500	204	19
08/07-04/08	Collars	01/01/2010	06/30/2010	$6.58	$11.62	74,000	(6)	16
12/07-04/08	Collars	07/01/2010	12/31/2010	$6.55	$11.08	69,500	(31)	-
04/08	Collars	01/01/2011	06/30/2011	$8.00	$9.85	62,000	108	-
							$(10,995)	$(2,375)

(1) The fair value of the Company's outstanding derivative contracts is presented on the balance sheet by counterparty. Amounts in parentheses indicate liabilities. All were designated as cash flow hedges.
(2) The crude oil hedges were entered into on a per barrel delivered price basis, using the West Texas Intermediate Index, with settlement for each calendar month occurring following the expiration date, as determined by the contracts.
(3) The natural gas hedges were entered into on a mmBtu delivered price basis, using the Houston Ship Channel Index, with settlement for each calendar month occurring following the expiration date, as determined by the contracts.

5. Derivative Instruments and Hedging Activity - continued

Interest Rate Risks-Related Hedging Activities: At September 30, 2008, a fixed-rate swap was in place on $100 million of borrowings under TXCO's Term Loan Agreement (See Note 7 for more information on this agreement) which locks the LIBOR portion of the interest rate at 3.305% until June 30, 2010. This equates to a total rate of 7.805% per annum on this debt. The fair market value of this derivative instrument was an asset of $0.1 million at September 30, 2008. The swap is designated as a cash flow hedge. No comparable derivative instrument was in place during 2007. An immaterial amount of ineffectiveness is expected on this derivative contract due to a difference in the rounding conventions for the LIBOR rate between the two documents.

The following table reflects the realized losses from derivatives included in "Interest expense" on the Consolidated Statements of Operations:

(in thousands)	**2008**	**2007**
For the three months ended September 30:		
Interest rate swap realized settlement losses	$206	$-
Interest rate swap ineffectiveness	7	-
Loss on interest rate swap contracts	$213	$-
For the nine months ended September 30:		
Interest rate swap realized settlement losses	$256	$-
Interest rate swap ineffectiveness	7	-
Loss on interest rate swap contracts	$263	$-

6. Comprehensive Income

Comprehensive income includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. The components of comprehensive income are as follows for the three- and nine-month periods ended September 30, 2008, and 2007:

(in thousands)	**2008**	**2007**
For the three months ended September 30:		
Net income	**$7,015**	$2,379
Other comprehensive income:		
Deferred hedge gain (loss)	**27,912**	(2,375)
Income tax (expense) benefit of cash flow hedges	**(9,490)**	879
Total comprehensive income	**$25,437**	$883
For the nine months ended September 30:		
Net income (loss)	**$21,396**	$(827)
Other comprehensive income (loss):		
Deferred hedge loss	**(2,159)**	(530)
Income tax benefit of cash flow hedges	**734**	196
Total comprehensive income (loss)	**$19,971**	$(1,161)

7. Long-Term Debt

Bank Credit Facilities: The Company has two credit facilities in place.

Senior Credit Agreement -- At September 30, 2008, the Company had a $125 million senior revolving credit facility with the Bank of Montreal (the "SCA"). The SCA was entered into in April 2007, amended in July 2007, and expires in April 2011.

At September 30, 2008, the borrowing base was $55.0 million, $30.0 million was outstanding at a weighted average interest rate of 4.67% and the unused borrowing base was $25.0 million. The SCA is secured by a first-priority security interest in TXCO's and certain of its subsidiaries' proved oil and natural gas reserves and in the equity interests of such subsidiaries. In addition, TXCO's obligations under the SCA are guaranteed by these certain subsidiaries. As of October 31, 2008, the balance outstanding under the SCA was $40.0 million, with a weighted average interest rate of 4.50%, using the base rate option, and the unused borrowing base was $15.0 million.

Loans under the SCA are subject to floating rates of interest based on (1) the total amount outstanding under the SCA in relation to the borrowing base and (2) whether the loan is a LIBOR loan or a base rate loan. LIBOR loans bear interest at the LIBOR rate (for the applicable 1-, 2-, 3- or 6-month maturity chosen by the Company) plus the applicable margin, and base rate loans bear interest at the base rate plus the applicable margin. The applicable margin varies with the ratio of total outstanding to the borrowing base. For base rate loans it ranges from zero to 100 basis points and for LIBOR rate loans it ranges from 150 to 250 basis points.

Under the SCA, TXCO is required to pay a commitment fee on the difference between amounts available under the borrowing base and amounts actually borrowed. The commitment fee is (1) 0.375%, so long as the ratio of amounts outstanding under the SCA to the borrowing base is less than 30%, and (2) 0.50%, in the event such ratio is 30% or greater. Borrowings under the SCA may be repaid and reborrowed from time to time without penalty.

Term Loan Agreement -- At September 30, 2008, the Company had a $100 million five-year term loan facility with Bank of Montreal (the "TLA") and certain other financial institutions party thereto with a current interest rate of 8.25%. Loans under the TLA are subject to floating rates of interest equal to, at TXCO's option, the LIBOR rate plus 4.50% or the base rate plus 3.50%. The "LIBOR rate" and the base rate are calculated in the same manner as under the SCA. See additional discussion regarding the interest rate swap in Note 5.

Borrowings under the TLA may be repaid (but not reborrowed). Additionally, no prepayments are permitted if the ratio of the total amount outstanding under the SCA to the borrowing base thereunder exceeds 75% or if any default exists under the SCA.

Both the SCA and the TLA contain certain restrictive covenants, as defined in the agreements, which, among other things, limit the incurrence of additional debt, investments, liens, dividends, redemptions of capital stock, prepayments of indebtedness, asset dispositions, mergers and consolidations, transactions with affiliates, derivative contracts, sale leasebacks and other matters customarily restricted in such agreements. The amended SCA and TLA require TXCO and its subsidiaries to meet a maximum consolidated leverage ratio of 3.00 to 1.00, a minimum current assets to current liabilities ratio of 1.00 to 1.00, a minimum interest coverage ratio of 2.00 to 1.00 and a minimum net present value to consolidated total debt ratio of 1.50 to 1.00. The ratios are calculated on a quarterly basis. The Company was in compliance with all such covenants at September 30, 2008. Both agreements also contain customary events of default. If an event of default occurs and is continuing, lenders with a majority of the aggregate outstanding term loans may require Bank of Montreal to declare all amounts outstanding under the SCA and TLA to be immediately due and payable.

8. Output Acquisition

On April 2, 2007, TXCO's acquisition of Output Exploration, LLC, a Delaware limited liability company ("Output"), was closed and became effective. Accordingly, the results of operations of Output are consolidated in these financial statements since that date. Pursuant to the terms of the Agreement and Plan of Merger, dated as of February 20, 2007, as amended (the "Merger Agreement"), by and among TXCO, Output Acquisition Corp., a Texas corporation and wholly-owned subsidiary of TXCO ("Merger Sub"), and Output, Output merged with and into Merger Sub (the "Merger"), with Merger Sub continuing as the surviving corporation and a wholly-owned subsidiary of TXCO. See Note L in the Company's Annual Report on Form 10-K for the year ended December 31, 2007, for further details about this acquisition.

The following unaudited pro forma data for the nine-month period ended September 30, 2007, includes the results of operations as if the Output acquisition had been consummated on January 1, 2007. The unaudited pro forma results do not purport to represent what our results of operations actually would have been if this acquisition had been completed on such date or to project our results of operations for any future date or period. Second quarter comparisons are not included since the second quarter for both years included the impact of the acquisition.

	Nine Month Period	
Pro Forma Income Statement Data *(in thousands)*	**2008**	**2007**
Revenues	**$122,711**	$67,790
Income (loss) from continuing operations, after pro forma provision for income taxes	**$21,396**	$(2,589)
Income (loss) from continuing operations available to common stockholders	**$17,573**	$(2,589)
Income (loss) from continuing operations, per share:		
Basic	**$0.51**	$(0.08)
Diluted	**$0.50**	$(0.08)

9. Commitments and Contingencies

The Convertible Preferred Stock Series D and Series E (the "Preferred") each contain make-whole provisions that provide for payments in the event that shares of the Preferred are converted into common stock within three years of their issuance. The make-whole provision is calculated as the present value of three years of dividends on the converted shares less any dividends already paid. See the "Subsequent Event" section in Note 10 that follows.

10. Preferred Stock Activity

Preferred Stock Issuances: On February 28, 2008, TXCO entered into an agreement related to the private placement of an aggregate of $20 million of shares of the Company's Series E Convertible Preferred Stock (the "Series E Preferred Stock") and the exchange of the issued and outstanding shares of its Series C Convertible Preferred Stock (the "Series C Preferred Stock") for shares of its Series D Convertible Preferred Stock (the "Series D Preferred Stock") pursuant to the Securities Purchase Agreement among the Company and the buyers listed therein. Closing and funding occurred in early March 2008.

The Series E Preferred Stock has a stated value of $1,000 per share and a par value of $0.01 per share, and is currently convertible into approximately 1.15 million shares of the Company's common stock at a conversion price of $17.36 per share. TXCO concurrently entered into call spread options related to the Series E Preferred Stock that may offset the dilution to common shares caused by a conversion of the Series E Preferred Stock at a time when the market price of the common shares is greater than $17.36 per share and less than or equal to $21.71 per share. For more information, see the discussion under the heading "SELLING STOCKHOLDERS' -- Private Placement and Share Exchange -- Call Spread Transactions" in the Company's 424B3 Prospectus filed with the Securities and Exchange Commission (the "SEC") on August 4, 2008, File No. 333-150107.

10. Preferred Stock Activity - continued

Additionally, in March 2008 the Company received notification that one of the purchasers of the Series D Preferred Stock was exercising its right to purchase additional shares of Series D Preferred Stock. The purchaser acquired an additional 13,909 shares of Series D Preferred Stock in early April 2008. The Series D Preferred Stock has a stated value of $1,000 per share and a par value of $0.01 per share. Payment for the subscribed shares was received in early April 2008. All other rights to acquire additional shares of Series D Preferred Stock expired unexercised in late March 2008.

At September 30, 2008, the shares of Series D Preferred Stock issued in April were convertible into 960,566 shares of TXCO common stock at a conversion price of $14.48 per share. TXCO concurrently entered into call spread options related to the newly issued shares of Series D Preferred Stock that may offset the dilution to common shares caused by a conversion of the Series D Preferred Stock at a time when the market price of the common shares is greater than $14.48 per share and less than or equal to $18.10 per share. Each call spread is a combination of a bought and a sold call option. For more information, see the discussion under the heading "SELLING STOCKHOLDERS' -- Private Placement and Share Exchange -- Call Spread Transactions" in the Company's 424B3 Prospectus filed with the SEC on August 4, 2008, File No. 333-150107.

Subsequent event: In October 2008, holders of 12,000 shares of TXCO Series D Preferred Stock, with an aggregate stated value of $12.0 million and a conversion price of $14.48, converted those shares into a total of approximately 829,000 shares of TXCO's common stock. An additional 231,000 of TXCO common stock were issued for the make-whole provision related to preferred dividends. The issuance of these shares will be recorded in the fourth quarter of 2008.

11. Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, "Fair Value Measurement" ("SFAS No. 157"). SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value, but does not expand the use of fair value in any new circumstances. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those years. The adoption of SFAS No. 157 did not have a material impact on the Company's consolidated financial statements. See Note 12.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS No. 159). SFAS No. 159 allows entities the option to measure eligible financial instruments at fair value as of specified dates. Such election, which may be applied on an instrument by instrument basis, is typically irrevocable once elected. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007, and early application is allowed under certain circumstances. The Company did not elect the fair value option for any of its existing financial instruments other than those mandated by other FASB standards and accordingly the impact of the adoption of SFAS No. 159 on TXCO's financial statements was immaterial.

In December 2007, the FASB issued SFAS No. 141(R), "Business Combinations" ("SFAS 141(R)"), which replaces SFAS 141. SFAS 141(R) establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non-controlling interest in the acquiree and the goodwill acquired. The Statement also establishes disclosure requirements, which will enable users to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008. The adoption of SFAS 141(R) will have an impact on accounting for business combinations once adopted, but the effect is dependent upon acquisitions at that time.

11. Recent Accounting Pronouncements - continued

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements -- an amendment of Accounting Research Bulletin No. 51" ("SFAS 160"), which establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the non-controlling interest, changes in a parent's ownership interest and the valuation of retained non-controlling equity investments when a subsidiary is deconsolidated. The Statement also establishes reporting requirements that provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the non-controlling owners. SFAS 160 is effective for fiscal years beginning after December 15, 2008. The Company does not currently have non-controlling interests in any of its subsidiaries and, therefore, does not expect the adoption of SFAS 160 to impact its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities -- an amendment of FASB Statement No. 133" (SFAS 161). SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," currently establishes the disclosure requirements for derivative instruments and hedging activities. SFAS 161 amends and expands the disclosure requirements of Statement 133 with enhanced quantitative, qualitative and credit risk disclosures. The Statement requires quantitative disclosure in a tabular format about the fair values of derivative instruments, gains and losses on derivative instruments and information about where these items are reported in the financial statements. Also required in the tabular presentation is a separation of hedging and non-hedging activities. Qualitative disclosures include outlining objectives and strategies for using derivative instruments in terms of underlying risk exposures, use of derivatives for risk management and other purposes and accounting designation, and an understanding of the volume and purpose of derivative activity. Credit risk disclosures provide information about credit risk related contingent features included in derivative agreements. SFAS 161 also amends SFAS No. 107, "Disclosures about Fair Value of Financial Instruments," to clarify that disclosures about concentrations of credit risk should include derivative instruments. This Statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption. This Statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company plans to apply this Statement beginning in 2009, and does not expect the application of this Statement on its disclosures to have a material impact in its Consolidated Financial Statements.

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles" ("FAS 162"). FAS 162 is effective 60 days following the Security Exchange Commission's approval of the Public Company Accounting Oversight Board Auditing amendments to AU Section 411, The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles." The statement is intended to improve financial reporting by identifying a consistent hierarchy for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles. The Company has not completed its evaluation of the effects, if any, which FAS 162 may have on its consolidated financial position, results of operations and cash flows.

12. Fair Value Measurements

Effective January 1, 2008, the Company adopted SFAS No. 157, "Fair Value Measurements," which defines fair value, establishes a framework for using fair value to measure assets and liabilities, and expands disclosures about fair value measurements. The Statement establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions of what market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of the inputs as follows:

Level 1: Quoted prices are available in active markets for identical assets or liabilities;
Level 2: Quoted prices in active markets for similar assets and liabilities that are observable for the asset or liability; or
Level 3: Unobservable pricing inputs that are generally less observable from objective sources, such as discounted cash flow models or valuations.

SFAS No. 157 requires financial assets and liabilities to be classified based on the lowest level of input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of the fair value of assets and liabilities and their placement within the fair value hierarchy levels. The following table presents TXCO's financial assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2008, by level within the fair value hierarchy:

	Fair Value Measurements Using		
(in thousands)	**Level 1**	**Level 2**	**Level 3**
Assets - Derivative instruments	$ -	$ -	$117
Liabilities - Derivative instruments	$ -	$ -	$10,995

TXCO's derivative financial instruments are comprised of costless collar agreements. The fair values of these agreements are determined based on both observable and unobservable pricing inputs and therefore, the data sources utilized in these valuation models are considered level 3 inputs in the fair value hierarchy.

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

(in thousands)	**Derivatives**	**Total**
Balance as of January 1, 2008	$(8,718)	$(8,718)
Total losses (realized or unrealized):		
Included in earnings *	(8,399)	(8,399)
Included in other comprehensive income *	6,239	6,239
Purchases, issuances and settlements	-	-
Transfers in and out of level 3	-	-
Balance as of September 30, 2008	$(10,878)	$(10,878)
Change in unrealized losses included in earnings (or changes in net assets) relating to derivatives still held as of September 30, 2008	$(2,160)	$(2,160)

* On the Consolidated Income Statements, realized gains or losses from commodity derivatives are included as adjustments to the "Oil and Gas Sales" revenues, while those from interest rate hedges are included in "Interest Expense." Unrealized losses or gains are included in "Other Comprehensive Income" in "Stockholders' Equity" on the Consolidated Balance Sheets, since these derivatives have been designated as cash flow hedges.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain statements in this report that are not historical in nature, including statements of TXCO's and management's expectations, intentions, plans and beliefs, are inherently uncertain and are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934. The following discussion should be read in conjunction with the unaudited consolidated financial statements and notes thereto included in this Form 10-Q, and with the Company's latest audited consolidated financial statements and notes thereto, and Management's Discussion and Analysis, as reported in its Form 10-K for the year ended December 31, 2007. See the "Disclosure Regarding Forward Looking Statements" section at the end of this Item 2. Unless the context requires otherwise, when we refer to "TXCO", "the Company", "we", "us" or "our", we are describing TXCO Resources Inc.

Overview

We are an independent oil and gas enterprise with interests primarily in the Maverick Basin of Southwest Texas, the Fort Trinidad area of East Texas, the onshore Gulf Coast region, the Marfa Basin of Texas, the Midcontinent region of Western Oklahoma, and shallow Gulf of Mexico waters. Our primary business operation is exploration, exploitation, development, production and acquisition of predominately onshore domestic oil and gas reserves. We have a consistent record of long-term growth in proved oil and gas reserves, leasehold acreage position, production and cash flow through our established exploration, exploitation and development programs.

Our business strategy is to build stockholder value by acquiring undeveloped mineral interests and internally developing a multi-year drilling inventory through the use of advanced technologies, such as 3-D seismic and horizontal drilling. We account for our oil and gas operations under the successful efforts method of accounting and trade our common stock on Nasdaq's Global Select Market under the symbol "TXCO."

Due to the number of promising prospects throughout our focus areas, as well as high oil and gas prices, drilling activity remained high during the last several years. For further discussion of this activity, see "Principal Areas of Activity" and "Drilling Activity" in Part I, Item 1 of our Annual Report on Form 10-K for the year ended December 31, 2007. The resulting increased expenditures continue to translate into increased reserves as we establish adequate production history. Recognition of additional reserves on newly drilled wells requires a period of sustained production, causing a delay between the expenditures and the recognition of reserves.

As of early November, we have six drilling rigs under contract and in operation on our Maverick Basin acreage and one rig in the Ft. Trinidad Field in East Texas. Our emphasis thus far this year has been on the Glen Rose, Pearsall and San Miguel formations. We began 71 new wells and 22 re-entries through October 31, including 30 in the Glen Rose Porosity. We have reviewed our remaining 2008 capital expenditures budget ("CAPEX") and drilling program and now plan to finish the remainder of the year operating within expected cash flow. Despite this operating curtailment during the fourth quarter, we are accelerating our Pearsall and Eagleford shale plays by electing to move to Phase II in both the EnCana and Anadarko farm-ins. We now expect to exceed our original 2008 capital budget of $125-135 million by year end. Initial plans for the 2009 capital budget assume drilling levels will be below 2008 and will be held within our cash flow projections.

During October 2008, oil and natural gas prices declined significantly, and still remain volatile. The decline in commodity prices will result in reduced revenues, net income and cash flows for the fourth quarter of 2008. Because forecasted oil and gas prices for the remainder of 2008 and for 2009 have dropped substantially, our initial 2009 CAPEX budget and drilling program has been set significantly below 2008 levels. We now plan that our 2009 CAPEX drilling program will be held within our anticipated 2009 cash flow. Any prolonged reduction in oil and natural gas prices could have a material adverse effect on our financial condition, operating results and cash flows, as well as access to debt and equity capital. Additionally, perceptions by oil and gas companies that oil and natural gas prices will be lower long-term can similarly reduce or defer major expenditures, which could impact our ability to attract partners for certain of our activities.

The United States, as well as other foreign countries are currently experiencing volatility in their financial and credit markets, which is having an adverse impact on some companies' ability to obtain credit. Many financial institutions have liquidity concerns, prompting government intervention to mitigate pressure on the credit markets. Our exposure to the current credit market condition includes our senior revolving credit facility. If the credit markets continue to be distressed, or oil and natural gas prices continue to decrease, the borrowing base under our senior revolving credit facility may be reduced or may not otherwise be increased. See "Bank Credit Facilities" below for further discussion of our senior revolving credit facility.

We have reviewed the creditworthiness of the banks and financial institutions with which we maintain our senior revolving credit facility, and which are counter-parties to our derivative arrangements. Thus far, our liquidity and financial position have not been materially impacted.

The comparison of 2008 year-to-date results with the prior year is impacted by the acquisition of Output Exploration, LLC in April 2007, for most of our income statement line items. See the Results of Operations section for the percentage impact on significant line items. Comparing the nine-month period ended September 30, 2008 with the same period of 2007:

- Oil and gas sales revenues increased 106.4%;
- Sales volumes were up 30% on a thousand cubic feet equivalent ("mcfe");
- Average realized prices were up $47.61 per barrel of oil ("bo") and $3.10 per thousand cubic feet of natural gas ("mcf"), excluding the impact of hedges; or $38.94 per bo and $3.81 per mcf, including the impact of hedges;
- Total costs and expenses increased 48.4%;
- Lease operating expenses increased by 33.3%; and
- Depreciation, depletion and amortization increased by 54.9%.

These factors resulted in net income available to common stockholders of $5.6 million and $17.6 million, for the three- and nine-month periods ended September 30, 2008. We recorded net income of $2.4 million for the third quarter of 2007, and a net loss of $0.8 million for the nine-month period ended September 30, 2007.

Net cash provided by operating activities ("operating cash flow") for year-to-date 2008 was $63.1 million, compared to $27.3 million for the same period in 2007. Operating cash flow is comprised of three main items: net income, adjustments to reconcile net income to operating cash flow before changes in working capital ("CF Adjustments"), and changes in working capital. For the nine months ended September 30, 2008, our net income was $21.4 million, as compared to a net loss of $0.8 million in the comparable prior year period. CF Adjustments (primarily non-cash items such as depreciation, depletion, amortization, impairment, share-based compensation and deferred taxes) were $51.5 million for the year-to-date period of 2008, as compared to $33.4 million in the same period of 2007. Depreciation, depletion and amortization caused most of the increase in CF Adjustments. Changes in working capital were a net use of funds of $9.8 million in the nine-month period of 2008, up from a net use of $5.2 million in the comparable prior year period.

Operational Data	**Three Months**			**Nine Months**		
for the periods ending September 30	**2008**	**2007**	**% Change**	**2008**	**2007**	**% Change**
Oil sales volumes (mbbls)	292.9	287.5	+2	848.2	679.6	+25
Gas sales volumes (mmcf)	706.2	652.0	+8	2,184.5	1,517.3	+44
Combined sales volumes (mboe)	410.6	396.2	+4	1,212.3	932.5	+30
Combined sales volumes (mmcfe)	2,463.6	2,377.0	+4	7,273.5	5,594.8	+30
Net residue and NGL sales volumes (mmbtu)	369,415	370,892	*	1,086,720	979,171	+11
Oil average realized sales price bbl,	$112.92	$71.59	+58	$111.95	$64.34	+74
excluding hedging impact of	-9.86	-0.39		-9.06	-0.39	
Gas average realized sales price per mcf,	$10.37	$6.77	+53	$10.23	$7.13	+43
excluding hedging impact of	-0.36	+0.19		-0.21	-0.92	
Residue & NGL average realized sales price per mmbtu	$11.45	$7.97	+44	$10.45	$8.37	+25
Oil - average daily sales (bopd)	3,183	3,125	+2	3,095	2,489	+24
Gas - average daily sales (mcfd)	7,668	7,087	+8	7,970	5,558	+43
Combined average daily sales (mboed)	4,461	4,306	+4	4,424	3,416	+30
Combined average daily sales (mmcfed)	26,766	25,837	+4	26,542	20,494	+30

* Less than 1% change

Liquidity and Capital Resources

Liquidity is a measure of ability to access cash. Our primary needs for cash are for exploration, exploitation, development and acquisition of oil and gas properties, repayment of contractual obligations and working capital funding. We have historically addressed our long-term liquidity requirements through cash provided by operating activities, the issuance of debt and equity securities when market conditions permit, sale of non-strategic assets, and through our credit facilities. The prices for future oil and natural gas production and the level of production have significant impacts on our operating cash flows and cannot be predicted with any degree of certainty. We continue to examine alternative sources of long-term capital, including bank borrowings, the issuance of debt instruments, the sale of equity securities, the sales of strategic and non-strategic assets, and joint-venture financing. However, if the capital markets continue to be distressed or oil and natural gas prices continue to decrease, our access to capital could be limited and, therefore, our ability to execute our operating strategy could be materially adversely effected.

Outlook: We believe our Bank Credit Facilities, described in the "Bank Credit Facilities" section, along with our current working capital and positive cash flow from existing production and anticipated production increases from new drilling will provide adequate capital to fund operating cash requirements and complete our scheduled exploration and development goals for the remainder of 2008. While we expect continued growth of our proved oil and gas reserves, our borrowing base may be reduced or may not otherwise be increased if the reduction in product prices are prolonged or the current credit market turmoil continues. We anticipate that our revenues will decrease significantly in the fourth quarter of 2008, primarily due to the decline in anticipated product prices.

We have reviewed our remaining 2008 CAPEX budget and drilling program and now plan to finish the remainder of the year operating within expected cash flow. Despite this operating curtailment during the fourth quarter, we are accelerating our Pearsall and Eagleford shale plays by electing to move to Phase II in both the EnCana and Anadarko farm-ins. We now expect to exceed our original 2008 capital budget of $125-135 million by year end. Initial plans for the 2009 capital budget assume drilling levels will be 35 to 40 % below 2008 and will be held within our cash flow projections.

Overriding Royalty Purchase Plan (the "ORRP"): At our annual meeting, held on May 30, 2008, TXCO's stockholders approved the adoption of the ORPP. The ORPP provides the Company the ability to purchase the overriding royalty interests in our existing and future oil and gas leases from Mr. James E. Sigmon, Chairman and Chief Executive Officer of TXCO, in one or more transactions in exchange for shares of our common stock, cash or a combination thereof, if and when purchase terms are agreed upon by the Board of Directors and Mr. Sigmon. The ORPP has 3,000,000 shares of common stock reserved for issuance, which is approximately 8.5% of the Company's issued and outstanding common stock as of October 31, 2008. Any issuance of such shares to Mr. Sigmon may have a dilutive effect on the Company's other common stockholders.

Bank Credit Facilities: We have two credit facilities in place, as follows:

Senior Credit Agreement -- At September 30, 2008, we had a $125 million senior revolving credit facility with the Bank of Montreal (the "SCA"). The SCA was entered into in April 2007, amended in July 2007, and expires in April 2011.

At September 30, 2008, the borrowing base was $55.0 million, $30.0 million was outstanding at a weighted average interest rate of 4.67% and the unused borrowing base was $25.0 million. The SCA is secured by a first-priority security interest in TXCO's and certain of its subsidiaries' proved oil and natural gas reserves and in the equity interests of such subsidiaries. In addition, TXCO's obligations under the SCA are guaranteed by these certain subsidiaries. As of October 31, 2008, the balance outstanding under the SCA was $40.0 million, with a weighted average interest rate of 4.50%, using the base rate option, and the unused borrowing base was $15.0 million.

Loans under the SCA are subject to floating rates of interest based on (1) the total amount outstanding under the SCA in relation to the borrowing base and (2) whether the loan is a LIBOR loan or a base rate loan. LIBOR loans bear interest at the LIBOR rate (for the applicable 1-, 2-, 3- or 6-month maturity chosen by the Company) plus the applicable margin, and base rate loans bear interest at the base rate plus the applicable margin. The applicable margin varies with the ratio of total outstanding to the borrowing base. For base rate loans it ranges from zero to 100 basis points and for LIBOR rate loans it ranges from 150 to 250 basis points.

Under the SCA, we are required to pay a commitment fee on the difference between amounts available under the borrowing base and amounts actually borrowed. The commitment fee is (1) 0.375%, so long as the ratio of amounts outstanding under the SCA to the borrowing base is less than 30%, and (2) 0.50%, in the event such ratio is 30% or greater. Borrowings under the SCA may be repaid and reborrowed from time to time without penalty.

Term Loan Agreement -- At September 30, 2008, we had a $100 million five-year term loan facility with Bank of Montreal (the "TLA") and certain other financial institutions party thereto with a current interest rate of 7.0%. Loans under the TLA are subject to floating rates of interest equal to, at our option, the LIBOR rate plus 4.50% or the base rate plus 3.50%. The LIBOR rate and the base rate are calculated in the same manner as under the SCA.

Borrowings under the TLA may be repaid (but not reborrowed) subject to a prepayment premium equal to (i) 1.0%, if prepaid prior to July 25, 2008 and (ii) 0.0%, thereafter. Additionally, no prepayments are permitted if the ratio of the total amount outstanding under the SCA to the borrowing base thereunder exceeds 75% or if any default exists under the SCA.

Both the SCA and the TLA contain certain restrictive covenants, as defined in the agreements, which, among other things, limit the incurrence of additional debt, investments, liens, dividends, redemptions of capital stock, prepayments of indebtedness, asset dispositions, mergers and consolidations, transactions with affiliates, derivative contracts, sale leasebacks and other matters customarily restricted in such agreements. The SCA and TLA require TXCO and its subsidiaries to meet a maximum consolidated leverage ratio of 3.00 to 1.00, a minimum current assets to current liabilities ratio of 1.00 to 1.00, a minimum interest coverage ratio of 2.00 to 1.00 and a minimum net present value to consolidated total debt ratio of 1.50 to 1.00. The ratios are calculated on a quarterly basis. We were in compliance with all such covenants at September 30, 2008. Both agreements also contain customary events of default. If an event of default occurs and is continuing, lenders with a majority of the aggregate outstanding term loans may require Bank of Montreal to declare all amounts outstanding under the SCA and TLA to be immediately due and payable.

Preferred Stock Placements: In March 2008, we issued 20,000 shares of our Series E Preferred Stock. The Series E Preferred Stock has a stated value of $1,000 per share and a par value of $0.01 per share. The holders are entitled to receive dividends, payable quarterly in cash, or at our option, TXCO common stock, at the rate of 6.0% per annum, and have preference over the common stock in the event of liquidation. These shares are currently convertible into approximately 1.15 million shares of the Company's common stock at a conversion price of $17.36 per share. TXCO concurrently entered into call spread options related to the Series E Preferred Stock that may offset the dilution to common shares caused by a conversion of the Series E Preferred Stock at a time when the market price is greater than $17.36 per share and less than or equal to $21.71 per share. For more information, see the discussion under the heading "SELLING STOCKHOLDERS -- Private Placement and Share Exchange -- Call Spread Transactions" in the Company's 424B3 Prospectus filed with the SEC on August 4, 2008, File No. 333-150107.

Also, in April 2008, we issued 13,909 additional shares of our Series D Preferred Stock. The Series D Preferred Stock has a stated value of $1,000 per share and a par value of $0.01 per share. The holders are entitled to receive dividends, payable quarterly in cash, or at our option, TXCO common stock, at the rate of 6.5% per annum, and have preference over the common stock in the event of liquidation. At October 31, 2008, the outstanding shares of our Series D Preferred Stock are convertible into approximately three million shares of TXCO's common stock at a conversion price of $14.48 per share. TXCO concurrently entered into call spread options related to the newly issued shares of Series D Preferred Stock that may offset the dilution to common shares caused by a conversion of the Series D Preferred Stock at a time when the market price of the common shares is greater than $14.48 per share and less than or equal to $18.10 per share. The terms of the April 2008 call spread options are substantially identical to those issued in November 2007. For more information, see the discussion under the heading "SELLING STOCKHOLDERS -- Private Placement and Share Exchange -- Call Spread Transactions" in the Company's 424B3 Prospectus filed with the SEC on August 4, 2008, File No. 333-150107.

A portion of the proceeds from each of these issuances was used to complement funding of our 2008 CAPEX drilling program. The registration statement for the preferred stock issuances was declared effective in early August 2008. TXCO has the option to pay dividends in cash or with shares of its common stock. To date, all dividends on the preferred stock have been paid in cash. See Note 10 in the accompanying Notes to Consolidated Financial Statements for more information.

Risk Management Activities -- Hedging Contracts: Due to the volatility of oil and natural gas prices and requirements under our Bank Credit Facilities, we periodically enter into price-risk management transactions (e.g., swaps, collars and floors) for a portion of our oil and natural gas production. We also have interest rate swaps on our long-term debt. In certain cases, this allows us to achieve a more predictable cash flow, as well as to reduce exposure from price fluctuations. The commodity hedges apply to only a portion of our production, and provide only partial price protection against declines in oil and natural gas prices, and may partially limit our potential gains from future increases in prices. None of these instruments are used for trading purposes.

On a quarterly basis, management sets all of our risk management policies, including quantities, types of instruments and counterparties. These policies are implemented by management through the execution of trades by the Chief Financial Officer after consultation with and concurrence by the Chief Executive Officer and the Board of Directors. Our Board of Directors monitors our risk management policies and trades.

All of our risk management instruments are considered derivatives and accounted for in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." When used, these derivative instruments are intended to hedge our price risk and may be considered hedges for economic purposes, but certain of these transactions may or may not qualify for cash flow hedge accounting. All derivative instrument contracts are recorded on the balance sheet at fair value. The change in fair value for the effective portion of contracts designated as cash flow hedges is recognized as Other Comprehensive Income (Loss) as a component in the Stockholders' Equity section of the Consolidated Balance Sheets, and is reclassified to income as the hedged transactions occur. The hedges are highly effective, and therefore, no hedge ineffectiveness has been recorded.

In accordance with the terms of our Bank Credit Facilities, we have entered into commodity derivative agreements. At October 31, 2008, collars were in place covering approximately 50% of our projected crude oil and natural gas sales over the next 3 years. Additionally, interest rate swaps locked in the interest rate on our $100 million TLA through June 30, 2010. See Note 5 to our consolidated financial statements for further information.

Sale of Assets: During third-quarter 2008, we closed on the sale of 15 non-core properties, primarily in South Texas and the Gulf of Mexico, to Traditions 2008 Investments, LLC for $9.6 million. The properties had approximately 1.3 mmcfed of net production and 3.7 bcfe of proved reserves prior to the sale. TXCO acquired the acreage through its 2007 purchase of Output Exploration LLC. Adjustments for revenues and expenses between the effective date and the closing date reduced proceeds to $8.4 million. An additional adjustment, approximately $1.0 million, is expected to be paid during the fourth quarter.

Sources and Uses of Cash: At December 31, 2007, our cash reserves were $9.8 million. During the first nine months of 2008, cash provided by operating activities was $63.1 million. Borrowings under the SCA of $51.7 million, net proceeds from the Series D Preferred Stock and Series E Preferred Stock, of $32.2 million, proceeds from the sale of the related upper call options of $9.3 million, $8.4 million from the sale of assets, and from the exercise of stock options of $0.9 million, resulted in total cash available of $175.4 million for use in meeting our ongoing operational and development needs.

Principal payments of $21.7 million were made on SCA during the first nine months of 2008. Interest payments on debt were $8.2 million. There were no federal income taxes paid during 2008. We applied $126.1 million to fund the ongoing development of our oil and gas producing properties, $11.6 million to the purchase of lower call options related to the Series D Preferred Stock and Series E Preferred Stock, $5.0 million for the purchase of other equipment, and $2.8 million for the payment of dividends on preferred stock.

We had a working capital deficit at September 30, 2008, including the net $5.5 million current liability associated with our derivatives, of $19.8 million, while the current ratio was 0.74 to 1. At year-end 2007, including the $5.2 million of derivative current liabilities, our working capital deficit was $23.9 million, while the current ratio was 0.60 to 1. We ended the first nine months of 2008 with a working capital deficit of $14.3 million, compared to negative working capital of $18.7 million at December 31, 2007 adjusted for the impact of the derivatives on current assets and liabilities. At September 30, 2008, our current ratio was 0.80 to 1 compared to 0.66 to 1 at year-end 2007, with the same adjustment.

At September 30, 2008, we had an unused borrowing base of $25.0 million under the SCA. Net cash provided by operating activities ("operating cash flow") for the first nine months of 2008 was $63.1 million, compared to $27.3 million in the same period of 2007. Operating cash flow is comprised of three main items: net income, adjustments to reconcile net income to net cash provided by operating activities ("CF Adjustments"), and changes in operating assets and liabilities. For the nine months ended September 30, 2008, our net income was $21.4 million, as compared to a net loss of $0.8 million in the comparable prior year period. CF Adjustments (primarily non-cash items such as depreciation, depletion, amortization, impairment, share-based compensation and deferred taxes) were $51.5 million for the year-to-date period of 2008, as compared to $33.4 million in the same period of 2007. Depreciation, depletion and amortization caused most of the increase in CF Adjustments. Changes in working capital were a net use of funds of $9.8 million in the nine-month period of 2008, up from a net use of $5.2 million in the comparable prior year period.

Results of Operations

The following table highlights the change for 2008 from the comparable period in 2007:

Change in Selected Income Statement Items for the Periods Ending September 30	Three Months		Nine Months	
	$ thousands	%	$ thousands	%
Oil and gas revenues	+12,231	+49	+56,274	+106
Lease operations	+1,805	+58	+3,342	+33
Depreciation, depletion & amortization	+1,148	+10	+13,850	+55
Income from operations	+7,614	+120	+33,203	+709
Net income / loss	+4,636	+195	+22,223	n/m
Income available to common stockholders	+3,216	+135	+18,400	n/m

n/m - % change not meaningful due to a move from loss to income for the period

The following table summarizes the change for 2008 from the comparable periods in 2007:

Change in Gas Gathering Results for the Periods Ending September 30	Three Months		Nine Months	
	$ thousands	%	$ thousands	%
Gas gathering revenues	+1,146	+36	+3,078	+35
Gas gathering operations expense	+788	+23	+2,332	+24
Gross margin	+358	n/m	+746	+94
Operational data:				
Total sales volumes (mmbtu)	-1,477	*	+107,549	+11
Average sales price ($ per mmbtu)	+$3.48	+44	+$2.08	+25

n/m - % change not meaningful due to a move from a negative to a positive gross margin for the period
* - % change is less than 1%

Three Months Ended September 30, 2008, Compared with Three Months Ended September 30, 2007:

Revenues

The 49% increase in oil and gas revenue is primarily due to higher average realized prices for crude oil and natural gas, as well as higher volumes for both products. Sales volumes increased 4% on a mcfe basis. Natural gas sales volumes were up 8% primarily due to increased production from the Fort Trinidad and Pearsall plays, partially offset by reductions reflecting normal maturing gas well decline curves and the sale of 15 non-core properties with 1.3 mmcfed of production during the quarter. Oil sales volumes increased 2% primarily due to Glen Rose Porosity wells put on production since September 30, 2007, largely offset by reductions in oil volumes on non-operated properties. Excluding the impact of hedging, average realized sales prices for natural gas were up 53%, while those for crude oil were up 58%. Derivative losses on hedges reduced revenues by $3.1 million for the quarter, compared with less than $0.1 million for the prior-year quarter.

Lease Operations ("LOE")

The 58% increase reflects costs related to 25 net oil wells and seven net gas wells placed on production since September 30, 2007, and increasing costs due to greater demand for third-party services in the field, partially offset by elimination of costs for properties sold during fourth quarter 2007 and reduced costs on properties for which we assumed operation.

Exploration Expenses

The 3% increase primarily reflects delay rental payments on certain leased properties.

Gas Gathering

The 36% increase in gas gathering revenues (and 23% increase in related expenses) reflects higher realized prices on essentially flat volumes.

Impairment

The 144% increase in impairment expense reflects increased impairment recognized due to current lower product prices and a reversal of prior period over accruals in 2007's third quarter.

Depreciation, Depletion and Amortization ("DD&A")

The 10% increase is due to higher finding costs, depletion rates and costs related to new wells placed on production over the last year.

General and Administrative ("G&A")

G&A expense was down slightly and, as a percentage of revenue, decreased to 7.0%, from 11.0% last year, primarily due to higher commodity sales prices. During second quarter 2008, G&A as a percentage of revenue was 8.0%.

Interest Expense

The 30% decrease was due to lower average outstanding balances on our revolving credit agreement, primarily due to some of the funds received in the preferred stock placements being used to repay outstanding borrowings.

Income Tax Expense

Our effective tax rate was 34.3%, up from 23.3% in the prior year period, as a result of reversals in that period of expense booked in earlier quarters due to changes in the Texas Gross Margin tax.

Nine Months Ended September 30, 2008, Compared with Nine Months Ended September 30, 2007:

Revenues

The 106% increase in oil and gas revenue is primarily due to the inclusion of three full quarters of Output revenues, along with higher average realized prices for crude oil and natural gas, as well as higher volumes for both products. Sales volumes increased 30% on a mcfe basis. Natural gas sales volumes were up 44% due to inclusion of Output volumes for the full period, as well as increased volumes in the Pearsall play, partially offset by reductions reflecting normal maturing gas well decline curves and the sale of 15 non-core properties with 1.3 mmcfed of production during the third quarter. Oil sales volumes increased 25% primarily due to Glen Rose Porosity wells put on production since September 30, 2007. Excluding the impact of hedging, average realized sales prices for natural gas were up 43%, while those for crude oil were up 74%. Derivative losses on hedges reduced revenues by $8.1 million for the period, compared with $1.7 million for the prior year period.

Lease Operations ("LOE")

The 33% increase reflects the inclusion of Output costs for the full year and costs related to 25 net oil wells and seven net gas wells placed on production since September 30, 2007, and increasing costs due to greater demand for third-party services in the field, partially offset by elimination of costs for properties sold during fourth quarter 2007 and third quarter 2008, and reduced costs on properties for which we assumed operation.

Exploration Expenses

The 61% increase primarily reflects delay rental payments on certain leased properties.

Gas Gathering

The 35% increase in gas gathering revenues (and 24% increase in related expenses) reflects higher realized prices and higher sales volumes.

Impairment

The 287% increase in impairment expense reflects increased impairment recognized due to currently projected lower product prices.

Depreciation, Depletion and Amortization ("DD&A")

The 55% increase is due to the inclusion of Output costs for the full year and higher finding costs, depletion rates and costs related to new wells placed on production over the last year.

General and Administrative ("G&A")

The $2.8 million increase was primarily due to higher non-cash stock compensation expense, proxy contest expenses and system conversion costs. G&A expense as a percentage of revenue decreased to 8.8%, from 12.9 % for the same period last year, primarily due to higher commodity sales prices. During first- and second-quarter 2008, G&A as a percentage of revenue was 12.5% and 8.0% respectively.

Interest Expense

The $0.1 million increase was due to our long-term financing related primarily to the April 2007 Output acquisition.

Income Tax Expense

Our effective tax rate was 28.3% due to the tax benefit received on the exercise of stock options during first quarter 2008. In the prior year we recorded a tax benefit of 53.8% due to reversals of previously recorded expenses due to changes in the Texas Gross Margin tax

Subsequent Event

In October 2008, holders of 12,000 shares of TXCO Series D Preferred Stock, with an aggregate stated value of $12.0 million and a conversion price of $14.48, converted those shares into a total of approximately 829,000 shares of TXCO's common stock. An additional 231,000 shares of TXCO common stock were issued for the make-whole provision related to preferred dividends. The issuance of these shares will be recorded in the fourth quarter of 2008.

Drilling Activities

We drilled or participated in drilling 86 wells in the first nine months of 2008. Of these wells, 73 were in the Maverick Basin, 11 were on former Output assets, and one each in South Dakota and the Marfa Basin of West Texas. In October 2008, we spudded seven additional wells. At October 31, 2008, of the 93 total wells that we participated in this year, 40 were on production, 36 were in completion or being evaluated for recompletion, six remained drilling, one was dry and will be plugged and abandoned, one was completed as a steam injection well, three were drilled as core tests, one was completed as a fracture stimulation monitor well, and five are circulating steam. Additionally, 12 wells that were in progress at year-end 2007 were placed on production in 2008. We have focused primarily on the Glen Rose, San Miguel and Pearsall formations thus far in 2008. By comparison, we participated in 76 wells during the first nine months of 2007. The following table shows net daily sales for the periods presented:

	Quarter Ended			**% Change from**	
Average net daily sales volumes :	**Sept. 30, 2008**	**June 30, 2008**	**Sept. 30, 2007**	**2nd Qtr 2008**	**3rd Qtr 2007**
Oil, bopd	3,184	3,385	3,125	-6	+2
Natural gas, mcfd	7,677	8,939	7,087	-14	+8
Oil equivalent, boed	4,463	4,875	4,306	-8	+4

Natural gas volumes increased due to new gas wells put on production in the first nine months of 2008. These new volumes were partially offset by normal production declines experienced on natural gas wells in the same period and the sale of 15 non-core properties with approximately 1.3 mmcfed of net production effective July 31, 2008.

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Maverick Basin

There are six rigs under contract to facilitate drilling or re-entry of almost 90 wells during 2008 in the Maverick Basin. TXCO owns two of these drilling rigs, which are being used primarily on shallow targets.

Glen Rose - During the first nine months of 2008, we drilled or re-entered 28 Glen Rose Porosity ("GRP") wells. We have not drilled shoal or reef wells in the Maverick Basin this year. We drilled or re-entered 32 GRP wells, and six wells targeting a Glen Rose reef or shoal, in the Maverick Basin in the comparable period of 2007.

Two GRP wells were begun in October 2008. As of October 31, 2008, of the 30 total 2008 GRP wells, 21 are on production, seven are in completion, and two continue drilling. Additionally, one GRP well that was in progress at year-end 2007 was put on production during 2008. Glen Rose average daily sales for third quarter 2008 were 2,374 bopd and 1.7 mmcfd, compared to 2,426 bopd and 1.9 mmcfd for the preceding quarter, and 2,260 bopd and 2.2 mmcfd for the comparable prior-year quarter. The annual hunting season drilling moratorium that impacts certain GRP leases will start in November, extending into January 2009.

Glen Rose targets in the Maverick Basin represent almost half of our 2008 CAPEX budget. We currently plan to drill or re-enter over 35 wells in the Porosity during 2008. In May 2008, Schlumberger completed a comprehensive reservoir optimization study that focused on multiple aspects of the GRP project, including the establishment of higher reserve levels, higher recovery rates, evaluating secondary recovery opportunities and overall operating efficiencies. TXCO's technical staff has modified certain of its procedures based on the study.

Georgetown - We drilled or re-entered 10 Georgetown wells in the first nine months of 2008, and one in October. Two of these wells are producing gas and two are producing oil, while five are in completion stage, one was dry and is waiting to be plugged and abandoned, and one continues drilling. For comparison, we participated in five Georgetown wells in the comparable prior year period. Our 2008 CAPEX budget includes six Georgetown wells. Georgetown average daily sales for third-quarter 2008 were 213 bopd and 169 mcfd, compared to 501 bopd and 850 mcfd for the preceding quarter, and 19 bopd and 93 mcfd for the prior-year third quarter.

San Miguel - San Miguel conventional oil average daily sales for third-quarter 2008 were 179 bopd, compared to 195 bopd for the preceding quarter, and 207 bopd for the prior-year third quarter. We spudded 11 San Miguel oil wells during the first nine months of 2008, and an additional two during October. Of the 13 San Miguel wells spudded this year, six are producing while seven await completion at October 31, 2008. Additionally, one San Miguel well that was in progress at year-end 2007 was put on production during 2008. Our CAPEX budget calls for 20 San Miguel wells in 2008. We began 10 San Miguel wells in the first nine months of 2007.

Oil Sands - High-temperature steam injection continues at the Steam-Assisted Gravity Drainage ("SAGD") pilot and initial oil shows have begun. Pre-heat steam circulation continues on the separate Fracture-Assisted-Steamflood-Technology ("FAST") pilot. The FAST pilot includes both a vertical, inverted five-spot well pattern and a horizontal three-well pattern that utilizes a modified FAST process. We hope to have a meaningful response on the SAGD project by the end of first-quarter 2009 and on the FAST projects by the end of second-quarter 2009. We started 12 Oil Sands wells during the first nine months of 2008 and one in October, including three core test wells for further sand evaluation. Our 2008 CAPEX includes $10.0 million for Oil Sands wells and related steam generators and surface equipment. Our partner is also contributing $10 million to this $20 million project.

Pearsall/Eagleford - Seven wells were spudded or re-entered targeting the Pearsall or Eagleford formations during the first nine months of 2008, and one in October. Four of the eight total wells are producing, while two await completion, and one continues drilling and one was completed as a fracture stimulation monitor well. Combined average daily sales for third-quarter 2008 for the two formation were 5 bopd and 328 mcfd, compared to 519 mcfd for the preceding quarter, and 50 mcfd for the prior-year third quarter. No oil sales were recorded from these two formations in the referenced prior quarters.

TXCO has completed the last of the wells required in Phase I of the 2007 farm-in agreement with EnCana Oil & Gas (USA). Based on the success of the three initial wells, we have elected to move to Phase II and plan to drill four additional Pearsall wells before July 1, 2009. On the Anadarko Petroleum Corporation farm-in, four wells have been drilled (two Pearsall and two Eagleford). We plan to move to Phase II under this agreement and drill four additional wells within the next year. St. Mary Land & Exploration Company is also participating with us under this agreement.

Other Areas

Output Properties - Operations are ongoing on former Output properties. 11 wells were spudded during the first nine months of 2008, five of which targeted Glen Rose shoals in the Fort Trinidad Field. At October 31, 2008, two are producing, eight are awaiting completion and one continues drilling. Additionally, six wells spudded in 2007 were put on production during 2008. Average daily sales for third-quarter 2008 on former Output properties were 305 bopd and 5.4 mmcfd, compared to 492 bopd and 6.1 mmcfd for the preceding quarter, and 580 bopd and 4.6 mmcfd for the prior-year third quarter. Third-quarter 2008 sales on these properties were down compared to second-quarter 2008, primarily due to the sale of 15 non-core properties with approximately 1.3 mmcfed of net production during the third quarter, as well as hurricane-related shut-ins of non-operated Gulf Coast production. We participated in 10 new wells or re-entries through September 30, 2007, after our acquisition in April 2007. We expect to participate in about 14 wells this year on prospects acquired through Output.

Disclosure Regarding Forward Looking Statements

Statements in this Form 10-Q which are not historical, including statements regarding TXCO's or management's intentions, hopes, beliefs, expectations, representations, projections, estimations, plans or predictions of the future, are forwarding-looking statements and are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements include those relating to estimated cash flows, liquidity, financial results, or expected oil and natural gas prices, CAPEX drilling budget, production volumes, well test results, reserve levels and number of drilling locations, expected drilling plans, including the timing, category, number, depth, cost, profitability and/or success of wells to be drilled, expected geological formations or the availability of specific services, equipment or technologies. It is important to note that actual results may differ materially from the results predicted in any such forward-looking statements. Investors are cautioned that all forward-looking statements involve risks and uncertainty. These risks and uncertainties include: the costs and accidental risks inherent in exploring and developing new oil and natural gas reserves, the price for which such reserves and production can be sold, the current economic turmoil and its impact on capital markets and liquidity, environmental concerns affecting the drilling of oil and natural gas wells, impairment of oil and gas properties due to depletion or other causes, the uncertainties inherent in estimating quantities of proved reserves and cash flows, as well as general market conditions, competition and pricing. TXCO undertakes no obligation to revise or update any forward-looking statements, or to make any other forward-looking statements, whether as a result of new information, future events or otherwise. Please refer to the "Risk Factors" discussion in Part I, Item 1A of our Form 10-K for the year ended December 31, 2007, for additional information. This and all our previously filed documents are on file at the Securities and Exchange Commission and can be viewed on our website at www.txco.com. Copies of the filings are available from our Corporate Secretary without charge.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk represents the risk of loss that may impact the financial position, results of operations, or cash flows due to adverse changes in interest rates and commodity prices.

Interest Rate Risk: We are exposed to market risk through interest rates related to our credit facility borrowing. Our credit facilities borrowings are based on the LIBOR or prime rate plus an applicable margin and are used to assist in meeting our working capital needs. As of September 30, 2008, we had $130.0 million in total borrowings under our credit facilities at a weighted average interest rate of 7.42% per annum. During second-quarter 2008, we entered into interest rate swaps for our $100 million term loan that effectively locks the interest rate on that debt at 7.805% per annum until June 30, 2010. The impact of the swap agreement changes our weighted average interest rate at September 30, 2008, to 7.081% per annum. An annualized 100-basis point fluctuation in the interest rate charged on the floating rate balance of $30.0 million would have approximately $300,000 impact on our annual net income, before taxes.

Commodity Risk: Our major market-risk exposure is the commodity pricing applicable to our oil and natural gas production. Realized commodity prices received for such production are primarily driven by the prevailing worldwide price for crude oil and spot prices applicable to natural gas. Prices have fluctuated significantly during the last five years and such volatility is expected to continue, and the range of such price movement is not predictable with any degree of certainty. In the normal course of business we periodically enter into hedging transactions, including fixed price and ratio swaps to mitigate exposure to commodity price movements, but not for trading or speculative purposes.

During 2004 and 2005, due to the instability of prices and to achieve a more predictable cash flow, we put in place natural gas and crude oil swaps for a portion of our 2005 through 2007 production. These derivatives expired on April 30, 2007. TXCO entered into derivative agreements in August and December 2007, and April 2008, to cover approximately 50% of the Company's and its subsidiaries' aggregate projected oil and gas production anticipated to be sold in the ordinary course of its business during the upcoming three-year period, in accordance with terms of our term loan and revolving credit facilities. Please refer to Note 5 to the consolidated financial statements included herein for additional information on our commodity hedging contracts and activity.

The following is a list of derivative contracts outstanding as of September 30, 2008:

Transaction Date	**Trans-action Type**	**Beginning**	**Ending**	**Average Floor Price Per Unit**	**Average Ceiling Price Per Unit**	**Volumes Per Month**
Crude Oil - Bbl (1):						
08/07-08/08	Collars	01/01/2008	12/31/2008	$75.35	$97.09	35,500
08/07-08/08	Collars	01/01/2009	12/31/2009	$71.40	$87.41	20,700
08/07-08/08	Collars	01/01/2010	06/30/2010	$68.33	$80.77	15,000
12/07-04/08	Collars	07/01/2010	12/31/2010	$75.80	$100.35	13,200
04/08	Collars	01/01/2011	06/30/2011	$90.00	$122.80	11,500
Natural Gas - mmBtu (2):						
08/07-08/08	Collars	01/01/2008	12/31/2008	$6.61	$10.45	105,500
08/07-08/08	Collars	01/01/2009	12/31/2009	$6.60	$11.64	86,500
08/07-04/08	Collars	01/01/2010	06/30/2010	$6.58	$11.62	74,000
12/07-04/08	Collars	07/01/2010	12/31/2010	$6.55	$11.08	69,500
04/08	Collars	01/01/2011	06/30/2011	$8.00	$9.85	62,000

(1) These crude oil hedges were entered into on a per barrel delivered price basis, using the West Texas Intermediate Index, with settlement for each calendar month occurring following the expiration date, as determined by the contracts.
(2) These natural gas hedges were entered into on a mmBtu delivered price basis, using the Houston Ship Channel Index, with settlement for each calendar month occurring following the expiration date, as determined by the contracts.

Call Spread Transactions: In connection with our issuances of Series D Preferred Stock and Series E Preferred Stock, we entered into hedging transactions structured as issuer call spread transactions with Capital Ventures International (the "Counterparty"), one of the purchasers of the preferred stock. Each call spread transaction is a combination of a bought and sold call option with the Counterparty. We entered into three call spread transactions -- one corresponding to each of the November 2007 and the April 2008 issuances of our Series D Preferred Stock and one corresponding to the March 2008 issuance of our Series E Preferred Stock. The call options that we purchased from and sold to the Counterparty cover approximately the same number of shares of our common stock as the maximum number of shares of common stock subject to issuance upon conversion of our Series D Preferred Stock and Series E Preferred Stock.

The purpose of the call spread transactions is to effectively, by economic effect rather than by amendment to the terms of the applicable series of preferred stock, increase the conversion premium on our Series D Preferred Stock and Series E Preferred Stock from 20% to up to 50% of the price of our common stock price on the date of issuance of the preferred stock, depending on the price of our common stock on the conversion date, as well as, if exercised, the price of our common stock on the dates of exercise of the call spread options.

The call spread transactions have the economic effect of increasing the conversion premium by either the Counterparty paying us additional cash (as if we had sold the preferred stock for a higher price), in the case of a cash settlement, or the Counterparty acquiring shares in the open market and delivering them to us, thereby reducing the number of outstanding shares and putting us in the same position as if we had issued preferred stock with a higher conversion price, in the case of a net share settlement. The call spread transactions allow us to effectively increase the market price of our common stock at which dilution would otherwise occur upon conversion of our convertible preferred stock, from $14.48 to $18.10 per share of common stock for our Series D Preferred Stock, and from $17.36 to $21.71 per share of common stock for our Series E Preferred Stock.

Such options may result in dilution to the holders of our common stock in certain circumstances. For more information, see the discussion under the heading "SELLING STOCKHOLDERS' -- Private Placement and Share Exchange -- Call Spread Transactions" in the Company's 424B3 Prospectus filed with the SEC on August 4, 2008, File No. 333-150107.

For additional information, see also our Annual Report on Form 10-K for the year ended December 31, 2007, "Part II, Item 7A. Quantitative and Qualitative Disclosures About Market Risk."

ITEM 4. CONTROLS AND PROCEDURES

The SEC has adopted rules requiring reporting companies to maintain disclosure controls and procedures to provide reasonable assurance that a registrant is able to record, process, summarize and report the information required in the registrant's quarterly and annual reports under the Securities Exchange Act of 1934 (the "Exchange Act"). While we believe that our existing disclosure controls and procedures have been effective to accomplish these objectives, we intend to continue to examine, refine and formalize our disclosure controls and procedures and to monitor ongoing developments in this area.

Based on their evaluation as of September 30, 2008, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Exchange Act) are effective to provide reasonable assurance that the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is: (1) recorded, processed, summarized and reported within the time periods as specified in the SEC's rules and forms, and (2) accumulated and communicated to our management, including our chief executive and chief financial officers, as applicable, to allow timely decisions regarding required disclosure.

There have not been any changes in our internal control over financial reporting (as defined in Rule 13a-15(f) or 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we are involved in litigation arising out of our operations in the ordinary course of business. We maintain liability insurance, including product liability coverage, in amounts deemed adequate by management. To date, aggregate costs to us for claims have not been material. However, an uninsured or partially insured claim, or claim for which indemnification is not available, could have a material adverse effect on our financial condition or results of operations. We believe that there are no claims or litigation at this time, the outcome of which could have a material adverse effect on our financial position or results of operations. However, due to the inherent uncertainty of litigation, there can be no assurance that the resolution of any particular claim or proceeding will not have a material adverse effect on our financial position or results of operations for the fiscal period in which such resolution occurs.

We were not involved in any material litigation matters as of November 7, 2008.

ITEM 1A. RISK FACTORS

There have been no material changes in our risk factors from those disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

a) Exhibit 3.1 Amended and Restated Bylaws of TXCO Resources Inc. (incorporated herein by reference to Exhibit 3.1 of the Company's Form 8-K, filed August 18, 2008).

b) Exhibit 31.1 Certification of Chief Executive Officer required pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934; filed herewith.

c) Exhibit 31.2 Certification of Chief Financial Officer required pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934; filed herewith.

d) Exhibit 32.1 Certification of Chief Executive Officer required pursuant to 18 U.S.C. Section 1350 as required by the Sarbanes-Oxley Act of 2002; furnished herewith.

e) Exhibit 32.2 Certification of Chief Financial Officer required pursuant to 18 U.S.C. Section 1350 as required by the Sarbanes-Oxley Act of 2002; furnished herewith.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

TXCO RESOURCES INC.
(Registrant)

/s/P. Mark Stark
P. Mark Stark,
Chief Financial Officer
(Duly Authorized Officer)

Date: November 10, 2008