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KESTREL ENERGY INC  
Form 10QSB  
February 11, 2004

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-QSB

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the period ended DECEMBER 31, 2003

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-9261

KESTREL ENERGY, INC.

(Exact name of registrant as specified in its charter)

COLORADO

84-0772451

-----  
(State of other jurisdiction of incorporation or organization)

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

1726 COLE BLVD., STE. 210

80401

-----  
(Address of principal executive offices)

-----  
(Zip Code)

(303) 295-0344

-----  
(Registrant's telephone number, including area code)

Check whether the (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 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

APPLICABLE ONLY TO CORPORATE ISSUERS:

The number of shares outstanding of common stock, as of  
December 31, 2003: 9,798,400

KESTREL ENERGY, INC.

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### PART I. FINANCIAL INFORMATION

#### ITEM 1. Financial Statements

KESTREL ENERGY, INC.

BALANCE SHEETS AS OF DECEMBER 31, 2003 AND JUNE 30, 2003

ASSETS	December 31, 2003	June 30, 2003
CURRENT ASSETS:	(Unaudited)	
Cash and cash equivalents	\$ 64,132	\$ 128,604

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Accounts receivable	276,618	354,570
Other assets	8,869	18,400
	-----	-----
Total current assets	349,619	501,574
	-----	-----
PROPERTY AND EQUIPMENT, AT COST:		
Oil and gas properties, successful efforts method of accounting:		
Unproved	260,354	215,892
Proved	11,004,275	10,918,017
Pipeline and facilities	807,851	807,851
Furniture and equipment	53,363	52,703
	-----	-----
	12,125,843	11,994,463
Accumulated depreciation and depletion	(9,669,608)	(9,577,728)
	-----	-----
Net property and equipment	2,456,235	2,416,735
	-----	-----
	\$ 2,805,854	\$ 2,918,309
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
-----		
CURRENT LIABILITIES:		
Note payable-related party	\$ -	\$ 6,556
Accounts payable-trade	392,306	429,663
Accounts payable-related party	21,725	-
Accrued liabilities	87,423	69,998
	-----	-----
Total current liabilities	501,454	506,217
	-----	-----
LONG-TERM LIABILITIES:		
Line of credit-related party	\$ 200,000	\$ 191,860
Note payable-other	400,000	400,000
Asset retirement obligation	221,579	216,009
	-----	-----
Total long-term liabilities	821,579	807,869
	-----	-----
Total Liabilities	1,323,033	1,314,086
	-----	-----
STOCKHOLDERS' EQUITY:		
Preferred Stock, \$1 par value; 1,000,000 shares authorized, none issued	-	-
Common Stock, no par value; 20,000,000 shares authorized, 9,798,400 issued and outstanding at December 31, 2003 and June 30, 2003	20,394,585	20,394,585
Accumulated (deficit)	(18,911,764)	(18,790,362)
	-----	-----
Total stockholders' equity	1,482,821	1,604,223
	-----	-----
	\$ 2,805,854	\$ 2,918,309
	=====	=====

See accompanying notes to financial statements.

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KESTREL ENERGY, INC.  
 STATEMENTS OF OPERATIONS FOR THE THREE MONTHS AND SIX MONTHS ENDED DECEMBER 31,  
 2003 AND 2002  
 (Unaudited)

	Three months ended December 31,		Six months ended December 31,	
	2003	2002	2003	2002
REVENUE:				
Oil and gas sales	\$ 391,938	\$ 249,659	\$ 739,447	\$ 501,990
COSTS AND EXPENSES:				
Lease operating Expenses	221,507	160,316	370,406	271,520
Dry holes, abandoned and impaired properties	52,438	-	52,438	-
Exploration expenses	1,155	3,893	13,922	19,415
Depreciation and depletion	50,371	30,543	97,450	69,501
General and administrative	166,746	210,684	377,130	445,273
Interest / loan expense	17,802	64,539	35,535	79,813
TOTAL COSTS AND EXPENSES	510,019	469,975	946,881	885,522
OTHER INCOME (EXPENSE):				
Gain (loss) on sale of property and equipment	-	1,852	-	21,869
Gain (loss) on sale of available-for-sale securities	-	-	-	(92,774)
Interest	-	-	614	4,010
Other, net	63,477	14,834	85,418	36,635
	63,477	16,686	86,032	(30,260)
NET LOSS	\$ (54,604)	\$ (203,630)	\$ (121,402)	\$ (413,792)
OTHER COMPREHENSIVE INCOME (LOSS)				
Unrealized gain (loss) from available-for-sale securities	-	(17,250)	-	47,140
Comprehensive loss	(54,604)	(220,880)	(121,402)	(366,652)
Net Loss Per Common Share	\$ (0.01)	\$ (0.02)	\$ (0.01)	\$ (0.05)
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING	9,798,400	9,115,200	9,798,400	9,115,200

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See accompanying notes to financial statements.

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KESTREL ENERGY, INC.  
 STATEMENTS OF CASH FLOWS FOR THE SIX MONTHS ENDED DECEMBER 31, 2003 AND 2002  
 (Unaudited)

	2003	2002
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss	\$ (121,402)	\$ (413,792)
Adjustments to reconcile net loss to net cash used in operating activities:		
(Gain) loss on disposal of property	-	(21,869)
(Gain) loss on sale of available-for-sale securities	-	92,774
Depreciation and depletion	97,450	69,501
Other	1,584	-
(Increase) decrease in accounts receivable	77,952	38,421
(Increase) decrease in other current assets	9,531	150
Increase (decrease) in accounts payable	(37,357)	148,400
Increase (decrease) in accounts payable, related party	21,725	(25,238)
Increase (decrease) in accrued liabilities	17,425	34,224
Noncash interest expense	-	73,537
	66,908	(3,892)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Capital expenditures/acquisition of properties	(131,380)	(52,921)
Proceeds from sale of securities	-	56,241
Proceeds from sale of property	-	20,017
	(131,380)	23,337
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from issuance of debt	-	500,000
Repayments of borrowings	-	(516,000)
	-	(16,000)

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Net increase (decrease) in cash and cash equivalents	(64,472)	3,445
Cash and cash equivalents at the beginning of the period	128,604	56,548
	-----	-----
Cash and cash equivalents at the end of the period	\$ 64,132	\$ 59,993
	=====	=====
Cash paid for interest	\$ 35,536	\$ 6,276
	=====	=====

See accompanying notes to financial statements.

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KESTREL ENERGY, INC.

### NOTES TO FINANCIAL STATEMENTS

#### 1. Basis of Presentation

These condensed financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company's Annual Report on Form 10-KSB for the fiscal year ended June 30, 2003.

In the opinion of management, the accompanying interim unaudited financial statements contain all the adjustments necessary to present fairly the financial position of the Company as of December 31, 2003, the results of operations for the periods shown in the statements of operations, and the cash flows for the periods shown in the statements of cash flows. All adjustments made are of a normal recurring nature.

#### 2. Classification of Leasehold Cost

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, "Business Combinations," which requires the purchase method of accounting for business combinations initiated after June 30, 2001, and eliminates the pooling-of-interests method. In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets," which discontinues the practice of amortizing goodwill and indefinite lived intangible assets and initiates an annual review for impairment. Intangible assets with a determinable useful life will continue to be amortized over the period. The oil and gas industry is currently discussing the appropriate balance sheet classification of oil and gas mineral rights held by lease or contract. The Company classifies these assets as a component of oil and gas properties in accordance with its interpretation of SFAS No. 19 and common industry practice. There is also a view that these mineral rights are intangible assets as defined in SFAS No. 141, "Business Combinations", and, therefore, should be classified separately on the balance sheet as intangible assets.

The Company did not change or reclassify contractual mineral rights included in oil and gas properties on the balance sheet upon adoption of SFAS No. 141. The Company believes its current accounting of such mineral

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rights, as part of oil and gas properties is appropriate under the full cost method of accounting. However, if the accounting for mineral rights held by lease or contract is ultimately changed so that costs associated with mineral rights not held under fee title are, pursuant to the guidelines of SFAS no. 141, required to be classified as long term intangible assets, then the reclassified amount as of December 31, 2003 would be approximately \$1,769,889 and the reclassified amount as of June 30, 2003 (the end of the Company's last completed fiscal year) would be approximately \$1,723,858. Management does not believe that the ultimate outcome of this accounting issue will have a significant impact on the Company's cash flows, results of operations or financial condition.

### 3. Asset Retirement Obligation

In 2001, FASB issued SFAS 143, "Accounting for Asset Retirement Obligations." SFAS 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This statement requires companies to record the present value of obligations associated with the retirement of tangible long-lived assets in the period in which it is incurred. The liability is capitalized as part of the related long-lived asset's carrying amount. Over time, accretion of the liability is recognized as an operating expense and the capitalized cost is depreciated over the expected useful life of the related asset. The Company's asset retirement obligations relate primarily to the plugging, dismantlement, removal, site reclamation and similar activities of its oil and gas properties. Prior to adoption of this statement, such obligations were accrued ratably over the productive lives of the assets through its depreciation, depletion and amortization for oil and gas properties without recording a separate liability for such amounts.

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The transition adjustment related to adopting SFAS 143 on July 1, 2002, was recognized as a cumulative effect of a change in accounting principle. The cumulative effect on net income of adopting SFAS No. 143 was a net favorable effect of \$10,890. At the time of adoption, total assets increased \$117,147, and total liabilities increased \$205,842. The amounts recognized upon adoption are based upon numerous estimates and assumptions, including future retirement costs, future recoverable quantities of oil and gas, future inflation rates and the credit-adjusted risk-free interest rate. Changes in asset retirement obligations during the year were:

Asset retirement obligations as of July 1, 2003	\$ 216,009
Liabilities incurred	--
Liabilities settled	--
Accretion expense (included in depreciation, depletion and amortization)	5,570
	-----
Asset retirement obligations as of December 31, 200	\$ 221,579
	=====

## ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

### OVERVIEW

The Company has spent much of the past few years cutting overhead and other

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costs, disposing of marginal properties, reducing its debt and streamlining its operations in an effort to recover from substantial losses it suffered in its unsuccessful development of the Greens Canyon Project in Wyoming. It now appears that the Company's efforts to redevelop the Greens Canyon Project and recover some or all of its investment may be nearing fruition. As previously disclosed, the Company has been investigating the feasibility of developing acreage in the Greens Canyon Project for coal bed methane. The Company has recently entered into a farmout arrangement with Sun Delta Inc. and Victoria Petroleum USA Inc. that calls for the expenditure of up to \$3,000,000 in development expenditures over the next 4 years, including a pilot program for the commercialization of coal bed methane gas reserves contained within the Big Red Coal and other coal reserves located throughout the acreage area. If the pilot program is successful, Kestrel will have the ability to go forward in the development phase with a retained interest of up to 20%. For the \$3,000,000 expenditure, Delta and Victoria will earn up to 90% of all acreage within the AMI down to the base of the Blair Formation, 90% of the existing Greens Canyon pipeline and access to Kestrel's 24 square mile proprietary 3-D seismic survey. The Company will retain a 10% ownership position following the expenditure by Delta and Victoria of the \$3,000,000 and will have the right, but not the obligation, to increase this position to 20%, on a ground floor basis, by paying back costs of \$300,000 plus interest. The initial area of focus will utilize data from previous conventional drilling, the Company's proprietary 24 square mile 3-Dimensional seismic survey and an existing Company owned pipeline with capacity for up to 8 million standard cubic feet per day. The current production and gas contracts associated with Kestrel's underlying Muddy/ Frontier field development have been excluded from this agreement. If the pilot project is successful and Delta and Victoria successfully complete the proposed development of the coal bed methane acreage, the Greens Canyon Project may become a productive and valuable asset of the Company in the future.

This report contains forward-looking statements. We use words such as "anticipate", "believe", "expect", "future", "may", "will", "should", "plan", "intend", and similar expressions to identify forward-looking statements. These statements are based on our beliefs and the assurances we made using information currently available to us. Because these statements reflect our current views concerning future events, these statements involve risks, uncertainties and assumptions. Our actual results could differ materially from the results discussed in the forward-looking statements. Some, but not all, of the factors that may cause these differences include those discussed in the risk factors in the Company's report on Form 10-KSB for the year ended June 30, 2003. You should not place undue reliance on these forward-looking statements. You should also remember that these statements are made only as of the date of this report and future events may cause them to be less likely to prove to be true.

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### LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2003, the Company had a working capital deficit of \$151,835. This compares to the Company's working capital deficit of \$4,643 as of June 30, 2003. The increase in working capital deficit of \$147,192 was largely attributable to a decrease in accounts receivable of \$77,952, a decrease in cash held of \$64,472 and an increase in accrued liabilities of \$17,425, offset by slightly lower trade payables. In order for the Company to fund its working capital deficit, steps could include further sales of existing non-core properties, sale of shares of the Company's common stock, and further reductions of general and administrative expenses.

Net cash provided by operating activities was \$66,908 for the six months ended December 31, 2003, an increase of \$70,800 over cash used by operations of \$3,892



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for the same period in 2002. Accounts receivable decreased \$77,952, or 28%, to \$276,618 during the period as compared to a decrease of \$38,421 a year ago. The decrease in accounts receivable was primarily attributable to lower gas revenues at the Greens Canyon field, Sweetwater County, Wyoming as a result of slightly lower production levels. Accounts payable decreased \$37,357, or 9%, to \$392,306 during the period versus an increase of \$148,400, or 61%, during the same period a year ago. The decrease in payables reflects the Company's liquidity improvements as a result of higher oil and gas prices and lower interest charges during the period. Accrued liabilities increased \$17,425, or 25%, to \$87,423 versus an increase of \$77,151 in 2002.

Net cash used in investing activities was \$131,380 for the six months ended December 31, 2003, versus cash provided of \$23,337 for the same period in 2002. The increase of \$108,043 was primarily due to the accelerated development of the Hilight CBM field, Campbell County, Wyoming and the lease acquisition of offsetting acreage at the Company's Lake Boeuf field. There was no gain or loss on the disposal of property for the six month period ended December 31, 2003 versus a gain on disposal of property of \$21,869 offset by a loss on disposal of available for sale securities of \$92,774 for the period ended December 31, 2002.

There was no cash used in financing activities for the six months ended December 31, 2003 versus cash used of \$16,000 a year ago.

### RESULTS OF OPERATIONS

The Company reported a loss of \$54,604, or 1 cent per share, for the three month period ended December 31, 2003. This compares with a loss of \$203,630, or 2 cents per share, for the same period a year ago. The lower loss in the current period is the result of higher oil and gas revenues, lower general and administrative expenses, lower interest expenses and higher other income received, which is primarily due to a \$50,000 payment for seismic data related to the farmout to Sun Delta Inc. and Victoria Petroleum USA Inc.

The Company's revenues for the three months ended December 31, 2003 were \$391,938 compared to \$249,659 during the same period of 2001, an increase of \$142,279, or 64%. The increase in revenues was a result of higher oil and gas prices received during the period on slightly lower production levels.

The Company's total revenues for the six month period ended December 31, 2003 were \$739,447 as compared to \$501,990 during the same period in 2002, an increase of \$237,457, or 32%.

The Company's total expenses for the second quarter ended December 31, 2003 increased \$40,044, or 9%, to \$510,019 as compared to \$469,975 a year ago. The increase in overall expenses this quarter is primarily due to higher lease operating, dry hole and DD&A expenses, offset by lower interest charges and lower general and administrative expenses. Production and operating expenses for the three month period increased \$61,191, or 38%, to \$221,507 versus \$160,316 for the same period a year ago. The increase in operating expenses for the period was primarily due to taxes on higher revenues.

Total expenses for the six months ended December 31, 2003 increased \$61,359, or 7%, to \$946,881 versus \$885,522 a year ago. The increase in overall expenses is primarily attributable to higher lease operating expenses and higher dry hole costs offset by lower general and administrative expenses and lower interest charges.

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ended December 31, 2003 were \$52,438. This is wholly attributed to the abandonment of the Chadron venture in Dawes County, Nebraska.

No dry holes, abandoned and impaired properties expense was recorded for the three months or six months ended December 31, 2002.

Exploration expenses for the quarter ended December 31, 2003 decreased \$2,738 or 70%, to \$1,155 from \$3,893 a year ago.

For the six months ended December 31, 2003, exploration expenses decreased \$5,493, or 28%, to \$13,922 versus \$19,415 a year ago. The decrease in costs incurred for the quarter reflects the Company's commitment to pay down debt and minimize the accounts payables position.

General and administrative costs for the three months ended December 31, 2003 decreased \$43,938 or 21%, to \$166,746 as compared to \$210,684 for the same period a year ago. The decrease in expenses was largely attributable to lower monthly rental obligations, elimination of Nasdaq fees and lower accounting fees, offset by higher insurance charges. The Company continues its commitment to decrease overhead costs as much as possible.

The Company's general and administrative expenses for the six months ended December 31, 2003 decreased \$68,143, or 15%, to \$377,130 from \$445,273.

Interest expense and fees decreased \$46,737, or 72%, to \$17,802 from \$64,539 for the three months ended December 31, 2003. This decrease is due to lower loan balances from those one year ago.

For the six months ended December 31, 2003, interest expense and fees decreased \$42,278, or 53%, to \$35,535 from \$79,813 a year ago.

### CRITICAL ACCOUNTING POLICIES

The Company follows the successful efforts method of accounting for its oil and gas activities. Accordingly, costs associated with the acquisition, drilling and equipping of successful exploratory wells are capitalized. Geological and geophysical costs, delay and surface rentals and drilling costs of unsuccessful exploratory wells are charged to expense as incurred. Costs of drilling development wells, both successful and unsuccessful, are capitalized. Upon the sale or retirement of oil and gas properties, the cost thereof and the accumulated depreciation or depletion are removed from the accounts and any gain or loss is credited or charged to operations.

Depreciation and depletion of capitalized oil and gas properties is computed on the units-of-production method by individual fields as the related proved reserves are produced. A reserve is provided for estimated future costs of site restoration, dismantlement, and abandonment activities, net of residual salvage value, as a component of depletion.

Pipeline and facilities are stated at original cost. Depreciation of pipeline and facilities is provided on a straight-line basis over the estimated useful life of the pipeline of twenty years.

Furniture and equipment are depreciated using the straight-line method over estimated lives ranging from three to seven years.

Management periodically evaluates capitalized costs of unproved properties and provides for impairment, if necessary, through a charge to operations.

Proved oil and gas properties are assessed for impairment on a field-by-field basis. If the net capitalized costs of proved properties exceeds the estimated

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undiscounted future net cash flows from the property, a provision for impairment is recorded to reduce the carrying value of the property to its estimated fair value.

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### ITEM 3. Controls and Procedures

#### Disclosure Controls and Procedures

At the end of the period reported on in this report, the Company carried out an evaluation, under the supervision and participation of the Company's Chief Executive and Principal Financial Officer (the "Officer") of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Securities Exchange Act Rule 13a-14. Based upon that evaluation, the Officer concluded that the Company's disclosure controls and procedures are effective in all material respects, with respect to the recording, processing, summarizing and reporting, within the time periods specified in the SEC's rules and forms, of information required to be disclosed by the Company in the reports the Company files or submits under the Exchange Act.

#### Internal Controls

There were no significant changes made in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation described above.

## PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS  
Not applicable

ITEM 2. CHANGES IN SECURITIES  
Not applicable

ITEM 3. DEFAULTS UPON SENIOR SECURITIES  
Not applicable

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

At the Company's annual meeting of shareholders on December 4, 2003, in Denver, Colorado, the Company's shareholders elected Barry D. Lasker, Timothy L. Hoops, Robert J. Pett, Kenneth W. Nickerson, John T. Kopcheff, Mark A. E. Syropoulo and Neil T. MacLachlan to the Company's Board of Directors. The shareholders also approved and ratified the selection of Wheeler Wasoff, P.C. as the Company's independent certified public accountants and auditors for the year ending June 30, 2004.

There were 9,798,400 shares of the Company's Common Stock issued and outstanding, of which 9,798,400 were entitled to vote at the meeting. Of that number, 5,288,150 were present in person or by proxy at the meeting. With respect to the election of directors, the votes were as follows: Mr. Lasker - 5,284,026 in favor, 4,124 withheld; Mr. Hoops - 5,284,026 in favor, 4,124 withheld; Mr. Pett - 5,284,826 in favor, 3,224 withheld; Mr. Kopcheff - 5,284,926 in favor, 3,224 withheld; Mr. Nickerson - 5,285,116 in favor, 3,034 withheld; Mr. Syropoulo - 5,285,116 in favor, 3,034 withheld; and Mr. MacLachlan - 5,285,116 in favor, 3,034 withheld. The selection of Wheeler Wasoff, P.C. received a vote of 5,281,842 shares for, 428 against and 5,880

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abstaining. Abstentions and broker non-votes were counted for purposes of establishing a quorum only. Only those votes cast for the election of directors and the other proposal were counted as voted in favor or affirmative votes.

ITEM 5. OTHER INFORMATION  
Not applicable

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ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

EXHIBIT NO. DESCRIPTION

- |    |  |
|----|--|
| 31 | Certificate of Chief Executive and Principal Financial Officer pursuant to Section 302 of The Sarbanes-Oxley Act of 2002   |
| 32 | Certification of Chief Executive and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

(b) Reports on Form 8-K

1. A report on Form 8-K under Item 12 dated October 16, 2003 was filed with the Commission on October 17, 2003.
2. A report on Form 8-K under Item 12 dated November 17, 2003 was filed with the Commission on November 18, 2003.

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SIGNATURES

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.

KESTREL ENERGY, INC.

-----  
(Registrant)

Date: FEBRUARY 11, 2004

/S/BARRY D. LASKER

-----  
Barry D. Lasker, President,  
Chief Executive Officer, Principal  
Financial Officer and Director

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