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KESTREL ENERGY INC
Form 10QSB
November 15, 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 September 30, 2004

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 Boulevard, Suite 210

80401

(Address of principal executive offices)

(Zip Code)

(303)295-0344

(Registrant's telephone number, including area code)

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

The number of shares outstanding of common stock, as of September 30, 2004:
10,133,200

KESTREL ENERGY, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

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KESTREL ENERGY, INC.

BALANCE SHEETS AS OF SEPTEMBER 30, 2004 AND JUNE 30, 2004

ASSETS	September 30, 2004	June 30, 2004

CURRENT ASSETS:	(Unaudited)	
Cash and cash equivalents	\$ 146,161	\$ 162,507
Accounts receivable	412,076	366,278
Other assets	31,862	12,171
	-----	-----
Total current assets	590,099	540,956
	-----	-----
PROPERTY AND EQUIPMENT, AT COST:		
Oil and gas properties, successful efforts method of accounting:		
Unproved	260,355	260,355
Proved	11,104,070	11,081,664
Pipeline and facilities	807,851	807,851
Furniture and equipment	62,665	54,207
	-----	-----
	12,234,941	12,204,077
Accumulated depreciation and depletion	(9,795,430)	(9,754,427)
	-----	-----
Net property and equipment	2,439,511	2,449,650
	-----	-----
	\$ 3,029,610	\$ 2,990,606
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Notes payable-related party	\$ 50,000	\$ 650,000
Accounts payable-trade	189,413	245,198
Accrued Liabilities	117,042	85,582
	-----	-----
Total current liabilities	356,455	980,780
	-----	-----
LONG-TERM LIABILITIES:		
Notes payable-related party	\$ 600,000	\$ --
Asset retirement obligation	178,910	177,126
	-----	-----
Total long-term liabilities	778,910	177,126
	-----	-----
Total Liabilities	1,135,365	1,157,906
	-----	-----
STOCKHOLDERS' EQUITY:		
Preferred Stock, \$1 par value; 1,000,000 shares authorized, none issued	--	--
Common Stock, no par value; 20,000,000 shares authorized, 10,133,200 issued and outstanding at September 30, 2004 and June 30, 2004	20,562,085	20,562,085
Accumulated (deficit)	(18,667,840)	(18,729,385)

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Total stockholders' equity	1,894,245	1,832,700
	\$ 3,029,610	\$ 2,990,606

See accompanying notes to financial statements.

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KESTREL ENERGY, INC.
 STATEMENTS OF OPERATIONS FOR THE THREE MONTHS ENDED
 SEPTEMBER 30, 2004 AND 2003
 (Unaudited)

REVENUE:		
Oil and gas sales	\$ 492,110	\$ 347,510
COSTS AND EXPENSES:		
Lease operating Expenses	191,532	148,898
Exploration expenses	24,613	12,767
Depreciation and depletion	42,789	47,079
General and administrative	170,599	210,384
TOTAL COSTS AND EXPENSES	429,533	419,128
OTHER INCOME (EXPENSE)		
Interest income	556	613
Interest expense	(18,594)	(17,734)
Other, net	17,006	21,941
Total other income (expense)	(1,032)	4,820
INCOME (LOSS) BEFORE INCOME TAXES	61,545	(66,798)
Provision for income tax	12,309	--
Tax benefit of net operating loss carryforward	(12,309)	--
NET INCOME (LOSS)	\$ 61,545	\$ (66,798)

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Basic earnings per share	\$ 0.01	\$ (0.01)
	=====	=====
Diluted earnings per share	\$ 0.01	\$ (0.01)
	=====	=====
Basic weighted average number of common shares outstanding	10,133,200	9,798,400
	=====	=====
Diluted weighted average number of common shares outstanding	10,151,216	9,798,400
	=====	=====

See accompanying notes to financial statements.

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KESTREL ENERGY, INC.
STATEMENTS OF CASH FLOWS FOR THE THREE MONTHS ENDED
SEPTEMBER 30, 2004 AND 2003
(Unaudited)

	2004	2003
	-----	-----
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	\$ 61,545	\$ (66,798)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and depletion	42,789	47,079
Other	-	1,584
(Increase) decrease in accounts receivable	(45,798)	111,449
(Increase) decrease in other current assets	(19,691)	10,295
Increase (decrease) in accounts payable	(55,785)	(116,213)
Increase (decrease) in accrued liabilities	31,460	12,178
	-----	-----
Net cash (used in) provided by operating activities	14,520	(426)
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures/acquisition of properties	(30,866)	(67,160)
	-----	-----
Net cash (used in) investing activities	(30,866)	(67,160)
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES:		

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Proceeds from issuance of debt-related	60,000	--
Repayments of borrowings-related	(60,000)	--
	-----	-----
Net cash (used in) financing activities	--	--
	-----	-----
Net increase (decrease) in cash and cash equivalents	(16,346)	(67,586)
Cash and cash equivalents at the beginning of the period	162,507	128,604
	-----	-----
Cash and cash equivalents at the end of the period	\$ 146,161	\$ 61,018
	=====	=====
Cash paid for interest	\$ 17,632	\$ 17,734
	=====	=====

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, 2004.

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 September 30, 2004, 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. Property and Equipment

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.

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

3. Asset Retirement Obligation

In 2001, FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 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.

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, 2004	\$ 177,126
Liabilities incurred	--
Liabilities settled	--
Accretion expense (included in depreciation, depletion and amortization)	1,784

Asset retirement obligations as of September 30, 2004	\$ 178,910
	=====

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4. Notes Payable

On January 24, 2003, the Company borrowed \$400,000 from R&M Oil and Gas, Ltd., ("R&M") of which Timothy L. Hoops, one of the Company's directors and its President and CEO, is a partner. That loan is due on January 31, 2005, bears interest at 12.5% per annum and is secured by the Company's oil and gas interests in Grady County, Oklahoma. In the event of a default under the terms of the R&M loan, and the sale of the collateral securing the loan, the Company would receive any remaining proceeds after payment to R&M of its expenses in connection with such sale(s) and any indebtedness due and payable to R&M under the loan. The proceeds from the R&M loan were used to retire the outstanding debt to Samson Exploration N.L. at that time and reduce the Company's accounts payable position. The R&M loan was approved

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unanimously by the Board of Directors with Mr. Hoops abstaining. On October 13, 2004, the R&M loan was extended to January 31, 2007 under the same terms and conditions.

On May 5, 2003, the Company entered into a Line of Credit Agreement with Barry D. Lasker, the Company's former President and CEO, for a maximum loan to the Company of \$200,000. Under the terms of the agreement all outstanding amounts were due on May 4, 2005 and bore interest at 10% per annum. The initial proceeds of the loan consisted of \$40,000 cash and the conversion to debt of approximately \$152,000 of unpaid wages and unreimbursed business expenses owed to Mr. Lasker by the Company. The Lasker loan was secured by the Company's oil and gas interests in Campbell County, Wyoming. In the event of a default under the terms of the Lasker loan, and the sale of the collateral securing the loan, the Company would receive any remaining proceeds after payment to Mr. Lasker of his expenses in connection with such sale(s) and the indebtedness due and payable to him under the loan. On February 5, 2004, Mr. Lasker assigned the \$200,000 Lasker Loan to Samson Exploration N.L. (a related party) and Mr. Lasker was paid off in full. The terms and conditions of the Samson loan are a continuance of the terms and conditions of the Lasker loan, except for the deletion of a provision providing for acceleration upon termination of Mr. Lasker's employment by the Company. The Samson loan, originally due on May 4, 2005, has been extended until May 4, 2006 also under the same terms and conditions.

On June 8, 2004, the Company borrowed \$50,000 from VP with an 8% interest rate which is to be paid on repayment of the loan. This is an unsecured loan due on demand. On July 13, the Company borrowed \$60,000 from VP with an 8% interest rate. This loan was repaid in full on August 31, 2004, including all accrued interest with a total of \$60,753.79 cash.

ITEM 2. Management's Discussion and Analysis of Financial Condition or Plan of Operation.

OVERVIEW

During the quarter the Company has continued its drive to cut costs and maximize revenues. We are pleased to show continued improvement in our bottom line and we can now look to the future with a sound asset base and positive cash flow to pursue additional growth opportunities. In addition, the development of our Hilight coalbed methane (CBM) play in Campbell County, Wyoming has continued to provide us with a steady increase in reserves.

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 fiscal year ended June 30, 2004. 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 September 30, 2004, the Company had net working capital of \$233,644. This compares to the Company's working capital deficit of \$439,824 as of June 30, 2004. The increase in working capital of \$673,468 was primarily the result of the extensions of the loans from R&M Oil & Gas, Ltd. ("R&M") and Samson Exploration N.L. ("Samson") returning them to the status of long-term loans. The R&M loan was originally due on January 31, 2005 and has been extended to January 31, 2007 under the same terms and conditions. The Samson loan, originally due on May 4, 2005, has been extended until May 4, 2006 also under the same terms and conditions

Net cash provided by operating activities was \$14,520 for the three months ended September 30, 2004, an increase in provided cash of \$14,946 over cash used in operations of \$426 for the same period in 2003. Accounts receivable increased \$45,798, or 13%, to \$412,076 during the period. The increase in accounts receivable was attributable to an increase in Joint Interest Billing receivables. Accounts payable decreased \$55,785, or 23%, to \$189,413 during the period versus a decrease of \$116,213, or 27%, during the same period a year ago. Accrued liabilities increased \$31,460, or 38%, to \$117,042 during the period versus an increase of \$12,178 for the period ended September 30, 2003.

Net cash used by investing activities was \$30,866 for the quarter ended September 30, 2004, versus cash used of \$67,160 for the same period in 2003.

No cash was used by financing activities for the three-months ended September 30, 2003, or 2004.

RESULTS OF OPERATIONS

First Quarter Results

The Company reported net income of \$61,545, or 1 cent per share, for the three-month period ended September 30, 2004. This compares with a loss of \$66,798, or 1 cent per share, for the same period a year ago. The net income in the current period is a result of higher oil and gas sales and lower general and administrative expenses for the three months ended September 30, 2004 as compared to the same period last year.

The Company's revenues for the three months ended September 30, 2004 were \$492,110 compared to \$347,510 during the same period of 2003, an increase of \$144,600, or 42%. The increase in oil and gas revenues is attributable to higher production in several new wells put in place near the end of fiscal year 2004 in the Hilight CBM wells located in Campbell Co., Wyoming. Higher production levels were also attained in the Green River Basin due to better production techniques.

The Company's total expenses increased \$10,405, or 2%, to \$429,533 as compared to \$419,128 a year ago. The increase in overall expenses is primarily attributable to higher lease operating expense and exploration expense offset by lower general and administrative expense as discussed below. Production and operating expenses increased \$42,634, or 29%, to \$191,532 versus \$148,898 for the same period a year ago. The increase in production and operating expenses was largely due to higher revenues that translated into higher tax costs and higher production costs at the Company's Hilight CBM field due to a larger number of producing wells.

No dry holes, abandoned and impaired properties expense was recorded for the three months ended September 30, 2003, or 2004.

Exploration expenses increased \$11,846, or 93%, to \$24,613 from \$12,767 a year

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ago. The increase in exploration expense reflects the Company's interest in continued development at core properties.

General and administrative costs decreased \$39,785, or 19%, to \$170,599 as compared to \$210,384 for the same period a year ago. The decrease in expenses, though not attributable to any particular expense item, is representative of the Company's ongoing program to lower expenses.

Interest expense increased \$860 to \$18,594 from \$17,734 a year ago. The increase interest is attributable to short-term borrowings of approximately \$110,000 from Victoria Petroleum N.L.

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Total other income (expense) items decreased \$4,935, or 22%, to \$17,006 versus income of \$21,941 for the same period a year ago.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Company believes the following critical accounting policies affect our most significant judgments and estimates used in the preparation of our Financial Statements.

Property and Equipment

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.

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

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.

Asset retirement obligations

We recognize the future cost to plug and abandon wells over the estimated useful life of the wells in accordance with the provision of SFAS No.143. SFAS No.143 requires that we record a liability for the present value of the asset retirement obligation increase to the carrying value of the related long-lived

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asset. We amortize the amount added to the oil and gas properties and recognize accretion expense in connection with the discount liability over the remaining lives of the respective gas wells. Our liability estimate is based on our historical experience in plugging and abandoning wells, estimated well lives based on engineering studies, external estimates as to the cost to plug and abandon wells in the future and federal and state regulatory requirements. The liability is discounted using a credit-adjusted risk-free rate. Revisions to the liability could occur due to changes in well lives, or if federal and state regulators enact new requirements on the plugging and abandonment of wells.

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.

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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
None

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS
Not applicable

ITEM 3. DEFAULTS UPON SENIOR SECURITIES
Not applicable

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS
Not applicable

ITEM 5. OTHER INFORMATION
Not applicable

ITEM 6. EXHIBITS

Exhibit No. -----	Description -----
10.1	Loan Agreement with Victoria Petroleum N.L. dated June 8, 2004

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- 10.2 Allonge to Promissory Note to R&M Oil and Gas, Ltd.
dated October 13, 2004
- 10.3 Allonge to Promissory Not to Samson Exploration N.L.
dated October 29, 2004
- 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

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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: November 15, 2004

/s/TIMOTHY L. HOOPS

Timothy L. Hoops
President, Chief Executive Officer
and Principal Financial Officer

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