KESTREL ENERGY INC
Form 10QSB
February 14, 2005

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

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

For the period ended December 31, 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 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.

[X] Yes [ ] No

APPLICABLE ONLY TO CORPORATE ISSUERS:

The number of shares outstanding of common stock, as of December 31, 2004: 10,133,200

KESTREL ENERGY, INC.

INDEX TO UNAUDITED FINANCIAL STATEMENTS

PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

KESTREL ENERGY, INC.
BALANCE SHEETS as of december 31, 2004 and June 30, 2004

	December 31, 2004	June 30, 2004

	(Unaudited)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 236,999	$ 162,507
Accounts receivable	340,619	366,278
Other assets	27,739	12,171
Total current assets	605,357	540,956
PROPERTY AND EQUIPMENT, AT COST:		
Oil and gas properties, successful efforts method of accounting:		
Unproved	260,355	260,355
Proved	11,167,415	11,081,664
Pipeline and facilities	807,851	807,851
Furniture and equipment	64,612	54,207
	12,300,233	12,204,077
Accumulated depreciation and depletion	(9,838,895)	(9,754,427)
Net property and equipment	2,461,338	2,449,650
	$ 3,066,695	$ 2,990,606
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Note payable-related party	$ 50,000	$ 650,000
Accounts payable-trade	209,575	245,198
Accrued liabilities	86,238	85,582
Total current liabilities	345,813	980,780
LONG-TERM LIABILITIES:		
Notes payable-related party	$ 600,000	$ --
Asset retirement obligation	180,696	177,126
Total long-term liabilities	780,696	177,126
Total Liabilities	1,126,509	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 December 31, 2004 and June 30, 2004	20,562,085	20,562,085
Accumulated (deficit)	(18,621,899)	(18,729,385)
Total stockholders' equity	1,940,186	1,832,700
	$ 3,066,695	$ 2,990,606

See accompanying notes to financial statements.

KESTREL ENERGY, INC.
STATEMENTS OF OPERATIONS FOR THE THREE MONTHS AND SIX MONTHS
ENDED December 31, 2004 and 2003
(Unaudited)

	Three months ended December 31, 2004	Three months ended December 31, 2003	Six 2004
REVENUE:			
Oil and gas sales	$ 499,854	$ 391,938	$ 991,9
COSTS AND EXPENSES:			
Lease operating Expenses	235,297	221,507	420,2
Dry holes, abandoned and impaired properties	--	52,438	
Exploration expenses	11,664	1,155	42,8
Depreciation and depletion	45,251	50,371	88,0
General and administrative	157,603	166,746	328,2
TOTAL COSTS AND EXPENSES	449,815	492,217	879,3
OTHER INCOME (EXPENSE):			
Interest income	39	--	5
Interest expense	(19,394)	(17,802)	(37,9
Other, net	15,257	63,477	32,2
Total other income (expense)	(4,098)	45,675	(5,1
INCOME (LOSS) BEFORE INCOME TAXES	$ 45,940	$ (54,604)	$ 107,4
Provision for income tax	20,213	--	47,2
Tax benefit of net operating loss carryforward	(20,213)	--	(47,2
NET INCOME (LOSS)	$ 45,940	$ (54,604)	$ 107,4
Basic earnings loss per share	$ 0.01	$ (0.01)	$ 0.
Diluted earnings loss per share	$ 0.01	$ (0.01)	$ 0.

Basic weighted average number of common Shares outstanding	10,133,200	9,798,400	10,133,2
Diluted weighted average number of common Shares outstanding	10,165,957	9,798,400	10,156,5

See accompanying notes to financial statements.

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KESTREL ENERGY, INC.
STATEMENTS OF CASH FLOWS FOR THE SIX MONTHS
ENDED DECEMBER 31, 2004 and 2003
(Unaudited)

	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net gain (loss)	$ 107,486	$(121,402)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and depletion	88,040	97,450
Other	--	1,584
(Increase) decrease in accounts receivable	25,659	77,952
(Increase) decrease in other current assets	(15,568)	9,531
Increase (decrease) in accounts payable	(35,623)	(37,357)
Increase (decrease) in accounts payable, related party	--	21,725
Increase (decrease) in accrued liabilities	656	17,425
Net cash (used in) provided by operating activities	170,650	66,908
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures/acquisition of properties	(96,158)	(131,380)
Net cash (used in) investing activities	(96,158)	(131,380)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of debt	60,000	--
Repayments of borrowings	(60,000)	--
Net cash provided by financing activities	--	--
Net increase (decrease) in cash and cash equivalents	74,492	(64,472)

Cash and cash equivalents at the beginning of the period	162,507	128,604
Cash and cash equivalents at the end of the period	$ 236,999	$ 64,132
Cash paid for interest	$ 37,988	$ 35,536

See accompanying notes to financial statements.

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 December 31, 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.

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)	3,570
Asset retirement obligations as of December 31, 2004	$180,696

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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 was originally 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. (a related party) at that time and reduce the Company's accounts payable position. The R&M loan was approved 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. 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 in full. The terms and conditions of the Samson loan are a continuance of the terms and conditions of the Lasker loan. The Samson loan, originally due on May 4, 2005, has been extended until May 4, 2006 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, for which no demand has yet been made. On July 13, 2004, 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 in cash.

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

OVERVIEW

During the quarter we have 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 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 December 31, 2004, the Company had net working capital of $259,544. This compares to the Company's working capital deficit of $439,824 as of June 30, 2004. The increase in working capital of $699,368 was primarily the result of the extensions of the loans from R&M Oil & Gas, Ltd. ("R&M") and Samson Exploration N.L. ("Samson"), which returned 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 $170,650 for the six months ended December 31, 2004, an increase of $103,742 over cash provided by operations of $66,908 for the same period in 2003, a 155% increase. Accounts receivable decreased $25,659, or 8%, to $340,619 during the period as compared to a decrease of $77,952 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 $35,623, or 17%, to $209,575 during the period versus a decrease of $37,357, or 9%, 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. Accrued liabilities increased $656, or 1%, to $86,238 versus an increase of $17,425 in 2003.

Net cash used in investing activities was $96,158 for the six months ended December 31, 2004, versus cash used of $131,380 for the same period in 2003. The decrease of $35,222, or 27%, was primarily due to the decelerated development of the Hilight CBM field, Campbell County, Wyoming. There was no gain or loss on the disposal of property for the six-month period ended December 31, 2003 or 2004.

There was no cash used in financing activities for the six months ended December 31, 2003 or 2004.

RESULTS OF OPERATIONS

The Company reported income of $45,940, or 1 cent per share, for the three-month period ended December 31, 2004. This compares with a loss of $54,604, 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 offset by slightly higher lease operating and exploration expenses for the three-months ended December 31, 2004 as compared to the same period last year.

The Company reported income of $107,486, or 1 cent per share, for the six-month period ended December 31, 2004. This compares with a loss of $121,402, or 1 cent per share, for the same period a year ago. The net income in the six-month period is again a result of higher oil and gas sales, no abandoned properties and lower general and administrative expenses offset by slightly higher lease operating and exploration expenses as compared to the same period last year.

The Company's revenues for the three months ended December 31, 2004 were $499,854 compared to $391,938 during the same period of 2003, an increase of $107,916, or 28%. The increase in revenues was a result of higher oil prices received during the period and slightly higher gas production levels.

The Company's total revenues for the six month period ended December 31, 2004 were $991,964 as compared to $739,447 during the same period in 2003, an increase of $252,517, or 34%.

The Company's total expenses for the second quarter ended December 31, 2004 decreased $42,402, or 9%, to $449,815 as compared to $492,217 a year ago. The decrease in overall expenses this quarter is primarily due to slightly higher lease operating and exploration expenses, offset by lower general and administrative expenses, and no abandoned property. Production and operating expenses for the three-month period increased $13,790, or 6%, to $235,297 versus $221,507 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, 2004 decreased $32,000, or 4%, to $879,346 versus $911,346 a year ago. The decrease in overall expenses is primarily attributable to higher lease operating and exploration expenses offset by lower general and administrative expenses, lower depreciation and depletion expenses and no abandoned property.

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No dry holes, abandoned and impaired properties expense was recorded for the three months or six months ended December 31, 2004. Dry hole, abandoned and impaired properties for the three months and six months ended December 31, 2003 were $52,438. This was wholly attributed to the abandonment of the Chadron venture in Dawes County, Nebraska. Exploration expenses for the quarter ended December 31, 2004 increased $10,509 or 909%, to $11,664 from $1,155 a year ago. For the six months ended December 31, 2004, exploration expenses increased $28,957, or 208%, to $42,879 versus $13,922 a year ago. The increase in exploration expense for both periods reflects the Company's interest in continued development at core properties.

General and administrative costs for the three months ended December 31, 2004 decreased $9,143 or 5%, to $157,603 as compared to $166,746 for the same period a year ago. The Company's general and administrative expenses for the six months ended December 31, 2004 decreased $48,930, or 13%, to $328,200 from $377,130. The decrease in expenses, for 3 and 6 month results, though not attributable to any particular expense item, is representative of the Company's ongoing program to lower expenses.

Interest expense and fees increased $1,592, or 9%, to $19,394 from $17,802 for the three months ended December 31, 2003. This increase is due to slightly higher loan balances from those one-year ago.

For the six months ended December 31, 2004, interest expense and fees increased $2,453, or 7%, to $37,988 from $35,535 a year ago, again due to slightly higher loan balances.

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 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.

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

(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

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.

/s/TIMOTHY L. HOOPS

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

Date: February 14, 2005