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ABRAXAS PETROLEUM CORP  
Form 10-Q  
November 06, 2006

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

FORM 10-Q

(Mark One)  QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006

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: 0-19118  
ABRAXAS PETROLEUM CORPORATION (Exact name of registrant as specified in its charter)

Nevada

74-2584033

(State of Incorporation)

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

500 N. Loop 1604 East, Suite 100, San Antonio, TX 78232

(Address of principal executive offices) (Zip Code)  
210-490-4788

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year,  
if changed since last report)

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 the filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer (as defined in Rule 12b-2 of the Exchange Act) or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

The number of shares outstanding of each of the issuer's classes of common stock, as of November 3, 2006.

| Class                        | Shares Outstanding |
|------------------------------|--------------------|
| Common Stock \$.01 Par Value | 42,666,577         |

Forward-Looking Information

We make forward-looking statements throughout this document. Whenever you read a statement that is not simply a statement of historical fact (such as statements including words like "believe", "expect", "anticipate", "intend", "plan", "seek", "estimate", "could", "potentially" or similar expressions), you must remember that these are forward-looking statements and that our expectations may not be correct, even though we believe they are reasonable. The forward-looking information contained in this document is generally located in the material set forth under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" but may be found in other locations as well. These forward-looking statements generally relate to our plans and objectives for future operations and are based upon our management's reasonable estimates of future results or trends. The factors that may affect our expectations regarding our operations include, among others, the following:

- o our high debt level;
- o our success in development, exploitation and exploration activities;
- o our ability to make planned capital expenditures;
- o declines in our production of natural gas and crude oil;
- o prices for natural gas and crude oil;
- o our ability to raise equity capital or incur additional indebtedness;
- o economic and business conditions;
- o political and economic conditions in oil producing countries, especially those in the Middle East;
- o price and availability of alternative fuels;
- o our restrictive debt covenants;
- o our acquisition and divestiture activities;
- o results of our hedging activities; and
- o other factors discussed elsewhere in this document.

In addition to these factors, important factors that could cause actual results to differ materially from our expectations ("Cautionary Statements") are disclosed under "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2005 which are incorporated by reference herein. All subsequent written and oral forward-looking statements attributable to us, or persons acting on our behalf, are expressly qualified in their entirety by the Cautionary Statements.

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ABRAXAS PETROLEUM CORPORATION  
FORM 10 - Q  
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Abraxas Petroleum Corporation  
Condensed Consolidated Balance Sheets  
(in thousands)

|                             | September 30,<br>2006<br>(Unaudited) | De    |
|-----------------------------|--------------------------------------|-------|
|                             | -----                                | ----- |
| Assets:                     |                                      |       |
| Current assets:             |                                      |       |
| Cash .....                  | \$ 1,029                             | \$    |
| Accounts receivable, net    |                                      |       |
| Joint owners.....           | 412                                  |       |
| Oil and gas production..... | 6,325                                |       |

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|                                                                    |    |         |       |
|--------------------------------------------------------------------|----|---------|-------|
| Other.....                                                         |    | 38      |       |
|                                                                    |    | -----   |       |
|                                                                    |    | 6,775   |       |
| Other current assets.....                                          |    | 576     |       |
|                                                                    |    | -----   |       |
| Total current assets.....                                          |    | 8,380   |       |
| Property and equipment:                                            |    |         |       |
| Oil and gas properties, full cost method of accounting:            |    |         |       |
| Proved.....                                                        |    | 342,645 |       |
| Other property and equipment.....                                  |    | 3,438   |       |
|                                                                    |    | -----   |       |
| Total.....                                                         |    | 346,083 |       |
| Less accumulated depreciation, depletion, and<br>amortization..... |    | 242,181 |       |
|                                                                    |    | -----   |       |
| Total property and equipment - net.....                            |    | 103,902 |       |
| Deferred financing fees, net .....                                 |    | 4,844   |       |
| Other assets .....                                                 |    | 1,205   |       |
|                                                                    |    | -----   |       |
| Total assets.....                                                  | \$ | 118,331 | \$    |
|                                                                    |    | =====   | ===== |

See accompanying notes to condensed consolidated financial statements

Abraxas Petroleum Corporation  
Condensed Consolidated Balance Sheets (continued)  
(in thousands)

|                                       |    |                                      |    |
|---------------------------------------|----|--------------------------------------|----|
|                                       |    | September 30,<br>2006<br>(Unaudited) |    |
|                                       |    | -----                                |    |
| Liabilities and Stockholders' Deficit |    |                                      |    |
| Current liabilities:                  |    |                                      |    |
| Accounts payable.....                 | \$ | 1,949                                | \$ |
| Oil and gas production payable.....   |    | 2,637                                |    |
| Accrued interest.....                 |    | 5,527                                |    |
| Other accrued expenses.....           |    | 1,490                                |    |
|                                       |    | -----                                |    |
| Total current liabilities.....        |    | 11,603                               |    |
| Long-term debt.....                   |    | 126,077                              |    |
| Future site restoration.....          |    | 986                                  |    |
|                                       |    | -----                                |    |

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|                                                        |    |           |    |
|--------------------------------------------------------|----|-----------|----|
| Total liabilities.....                                 |    | 138,666   |    |
| Stockholders' deficit:                                 |    |           |    |
| Common Stock, par value \$.01 per share-               |    |           |    |
| Authorized 200,000,000 shares; issued, 42,638,577 and  |    |           |    |
| 42,063,167 .....                                       |    | 426       |    |
| Additional paid-in capital.....                        |    | 163,812   |    |
| Accumulated deficit.....                               |    | (185,398) |    |
| Treasury stock, at cost, 35,562 and 56,477 shares..... |    | (285)     |    |
| Accumulated other comprehensive loss.....              |    | 1,110     |    |
|                                                        |    | -----     |    |
| Total stockholders' deficit.....                       |    | (20,335)  |    |
|                                                        |    | -----     |    |
| Total liabilities and stockholders' deficit.....       | \$ | 118,331   | \$ |
|                                                        |    | =====     |    |

See accompanying notes to condensed consolidated financial statements

Abraxas Petroleum Corporation  
Consolidated Statements of Operations  
(Unaudited)

|                                                    | Three Months Ended           |           | Ni    |
|----------------------------------------------------|------------------------------|-----------|-------|
|                                                    | September 30,                |           |       |
|                                                    | 2006                         | 2005 (1)  | 200   |
|                                                    | (in thousands, except per sh |           |       |
| Revenue:                                           |                              |           |       |
| Oil and gas production revenues.....               | \$ 12,847                    | \$ 13,829 | \$ 38 |
| Rig revenues.....                                  | 363                          | 330       | 1     |
| Other.....                                         | 6                            | 5         |       |
|                                                    | -----                        | -----     | ----- |
|                                                    | 13,216                       | 14,164    | 39    |
| Operating costs and expenses:                      |                              |           |       |
| Lease operating and production taxes.....          | 2,929                        | 3,007     | 8     |
| Depreciation, depletion, and amortization.....     | 3,631                        | 2,107     | 10    |
| Rig operations.....                                | 178                          | 176       |       |
| General and administrative (including              |                              |           |       |
| stock-based compensation of \$207, \$16, \$578 and | 1,052                        | 969       | 3     |
| \$57).....                                         |                              |           |       |
|                                                    | -----                        | -----     | ----- |
|                                                    | 7,790                        | 6,259     | 23    |
|                                                    | -----                        | -----     | ----- |
| Operating income .....                             | 5,426                        | 7,905     | 16    |
| Other (income) expense:                            |                              |           |       |

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|                                                                                             |         |          |       |
|---------------------------------------------------------------------------------------------|---------|----------|-------|
| Interest income.....                                                                        | (1)     | (11)     |       |
| Interest expense.....                                                                       | 4,440   | 3,700    | 12    |
| Amortization of deferred financing fees.....                                                | 398     | 403      | 1     |
| Other expense.....                                                                          | -       | 30       |       |
|                                                                                             | -----   | -----    | ----- |
|                                                                                             | 4,837   | 4,122    | 13    |
|                                                                                             | -----   | -----    | ----- |
| Earnings from continuing operations .....                                                   | 589     | 3,783    | 2     |
| Net income from discontinued operations (net of \$6,060<br>income tax expense in 2005)..... | -       | -        |       |
|                                                                                             | -----   | -----    | ----- |
| Net earnings .....                                                                          | \$ 589  | \$ 3,783 | \$ 2  |
|                                                                                             | =====   | =====    | ===== |
| Basic earnings per common share:                                                            |         |          |       |
| Net earnings per common from continuing operations                                          | \$ 0.01 | \$ 0.09  | \$    |
| Discontinued operations.....                                                                | -       | -        |       |
|                                                                                             | -----   | -----    | ----- |
| Net earnings per common share - basic.....                                                  | \$ 0.01 | \$ 0.09  | \$    |
|                                                                                             | =====   | =====    | ===== |
| Diluted earnings per common share:                                                          |         |          |       |
| Net earnings per common from continuing operations                                          | \$ 0.01 | \$ 0.09  | \$    |
| Discontinued operations.....                                                                | -       | -        |       |
|                                                                                             | -----   | -----    | ----- |
| Net earnings per common share - diluted.....                                                | \$ 0.01 | \$ 0.09  | \$    |
|                                                                                             | =====   | =====    | ===== |

1. Reflects retrospective adoption of SFAS 123R.

See accompanying notes to condensed consolidated financial statements

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Abraxas Petroleum Corporation  
Condensed Consolidated Statements of Cash Flows  
(Unaudited)

(in thousands)

|                                            | Nine Months Ended<br>September 30, |       |
|--------------------------------------------|------------------------------------|-------|
|                                            | -----<br>2006<br>-----             |       |
| Operating Activities                       |                                    |       |
| Net earnings .....                         | \$ 2,792                           | \$    |
| Income from discontinued operations.....   | -                                  |       |
|                                            | -----                              | ----- |
| Income from continuing operations.....     | 2,792                              |       |
| Adjustments to reconcile net income to net |                                    |       |

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|                                                                               |          |       |
|-------------------------------------------------------------------------------|----------|-------|
| cash provided by operating activities:                                        |          |       |
| Depreciation, depletion, and amortization.....                                | 10,767   |       |
| Amortization of deferred financing fees.....                                  | 1,193    |       |
| Accretion of future site restoration.....                                     | 76       |       |
| Stock-based compensation.....                                                 | 578      |       |
| Changes in operating assets and liabilities:                                  |          |       |
| Accounts receivable.....                                                      | 1,822    |       |
| Other .....                                                                   | (413)    |       |
| Accounts payable and accrued expenses.....                                    | (3,525)  |       |
|                                                                               | -----    | ----- |
| Net cash provided by continuing operations.....                               | 13,290   |       |
| Net cash (used in) provided by discontinued operations.....                   | -        |       |
|                                                                               | -----    | ----- |
| Net cash provided by operations                                               | 13,290   |       |
| Investing Activities                                                          |          |       |
| Capital expenditures, including purchases and development of properties ..... | (21,290) |       |
| Proceeds from the sale of oil and gas properties.....                         | 11,869   |       |
|                                                                               | -----    | ----- |
| Net cash used in continuing operations.....                                   | (9,421)  |       |
| Net cash provided by discontinued operations.....                             | -        |       |
|                                                                               | -----    | ----- |
| Net cash used in investing activities.....                                    | (9,421)  |       |
| Financing Activities                                                          |          |       |
| Proceeds from long-term borrowings.....                                       | 14,850   |       |
| Payments on long-term borrowings.....                                         | (18,300) |       |
| Proceeds from issuance of common stock (net).....                             | -        |       |
| Issuance of stock for compensation.....                                       | 116      |       |
| Deferred financing fees .....                                                 | -        |       |
| Exercise of stock options .....                                               | 452      |       |
|                                                                               | -----    | ----- |
| Net cash (used in) provided by continuing operations.....                     | (2,882)  |       |
| Net cash used in discontinued operations.....                                 | -        |       |
|                                                                               | -----    | ----- |
| Net cash used in financing activities.....                                    | (2,882)  |       |
|                                                                               | -----    | ----- |
| Increase (decrease) in cash.....                                              | 987      |       |
| Cash, at beginning of period.....                                             | 42       |       |
|                                                                               | -----    | ----- |
| Cash, at end of period.....                                                   | \$ 1,029 | \$    |
|                                                                               | =====    | ===== |
| Supplemental disclosure of cash flow information:                             |          |       |
| Interest paid.....                                                            | \$ 8,291 | \$    |
|                                                                               | =====    | ===== |
| Non-cash items:                                                               |          |       |
| Future site restoration.....                                                  | \$ 27    | \$    |
|                                                                               | =====    | ===== |

See accompanying notes to condensed consolidated financial statements

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Abraxas Petroleum Corporation  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)  
(tabular amounts in thousands, except per share data)

### Note 1. Basis of Presentation

The accounting policies followed by Abraxas Petroleum Corporation and its subsidiaries (the "Company" or "Abraxas") are set forth in the notes to the Company's audited financial statements in the Annual Report on Form 10-K filed for the year ended December 31, 2005. Such policies have been continued without change. Also, refer to the notes to those financial statements for additional details of the Company's financial condition, results of operations, and cash flows. All the material items included in those notes have not changed except as a result of normal transactions in the interim, or as disclosed within this report. The accompanying interim consolidated financial statements have not been audited by independent accountants, but in the opinion of management, reflect all adjustments necessary for a fair presentation of the Company's financial position and results of operations. Any and all adjustments are of a normal and recurring nature. The results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of results to be expected for the full year.

The consolidated financial statements include the accounts of the Company and its then wholly-owned foreign subsidiary, Grey Wolf Exploration Inc. ("Grey Wolf") for the 2005 period. On February 28, 2005 Grey Wolf closed an initial public offering, resulting in our substantial divestiture of our capital stock and operations in Grey Wolf. As a result of the disposal of Grey Wolf, the results of operations of Grey Wolf through February 28, 2005 are reflected in our financial statements as discontinued operations.

#### Stock-based Compensation.

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment". SFAS No. 123R is a revision of SFAS No. 123, "Accounting for Stock Based Compensation", and supersedes APB 25. Among other items, SFAS 123R eliminates the use of APB 25 and the intrinsic value method of accounting, and requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements.

The Company adopted SFAS 123R in the fourth quarter of 2005 using the "modified retrospective method". Under the "modified retrospective method" entities are permitted to restate financial statements of previous periods based on proforma disclosures made in accordance with SFAS 123. This standard requires the cost of all share-based payments, including stock options, to be measured at fair value on the grant date and recognized in the statement of operations. In accordance with this standard, all periods prior to January 1, 2005 were restated to reflect the impact of the standard as if it had been adopted on January 1, 1995, the original effective date of SFAS No. 123, "Accounting for Stock-Based Compensation". Also in accordance with the standard, the amounts that are reported in the statement of operations for the restated periods are the pro forma amounts previously disclosed under SFAS No. 123.

The Company currently utilizes a standard option pricing model (i.e., Black-Scholes) to measure the fair value of stock options granted to employees. While SFAS 123R permits entities to continue to use such a model, the standard also permits the use of a more complex binomial, or "lattice" model. Based upon research done by the Company on the alternative models available to value option grants, and in conjunction with the type and number of stock options expected to be issued in the future, the Company has determined that it will continue to use



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the Black-Scholes model for option valuation as of the current time.

SFAS 123R includes several modifications to the way that income taxes are recorded in the financial statements. The expense for certain types of option grants is only deductible for tax purposes at the time that the taxable event takes place, which could cause variability in the Company's effective tax rates recorded throughout the year. SFAS 123R does not allow companies to "predict" when these taxable events will take place. Furthermore, it requires that the benefits associated with the tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow

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as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. These future amounts cannot be estimated, because they depend on, among other things, when employees exercise stock options.

The following table summarizes the stock option activities for the nine months ended September 30, 2006 (in thousands except per share data):

|                                     | Shares                  | Weighted<br>Average<br>Option<br>Exercise<br>Price Per<br>Share | Weighted<br>Average<br>Grant<br>Date Fair<br>Value Per<br>Share | A     |
|-------------------------------------|-------------------------|-----------------------------------------------------------------|-----------------------------------------------------------------|-------|
|                                     | -----                   | -----                                                           | -----                                                           | ----- |
| Outstanding December 31, 2005.....  | 3,016                   | \$ 1.75                                                         | \$ 1.27                                                         | \$    |
| Granted.....                        | 188                     | \$ 5.32                                                         | \$ 3.82                                                         |       |
| Exercised.....                      | (575)                   | \$ 0.78                                                         | \$ 0.45                                                         |       |
| Expired or canceled.....            | (3)                     | \$ 4.39                                                         | \$ 3.33                                                         |       |
| Outstanding September 30, 2006..... | -----<br>2,626<br>===== | \$ 2.21                                                         | \$ 1.64                                                         | \$    |

The following table shows the weighted average assumptions used in the Black Scholes valuation of the fair value of option grants during 2006.

|                                                               |         |
|---------------------------------------------------------------|---------|
| Expected dividend yield.....                                  | 0%      |
| Volatility.....                                               | .884    |
| Risk free interest rate.....                                  | 4.81%   |
| Expected life.....                                            | 5.09    |
| Fair value of options granted (in thousands).....             | \$ 718  |
| Weighted average grant date fair value of options granted.... | \$ 3.82 |

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Additional information related to options at September 30, 2006 and December 31, 2005 is as follows:

|                          | September 30,<br>2006 | December 31,<br>2005 |
|--------------------------|-----------------------|----------------------|
|                          | -----                 | -----                |
| Options exercisable..... | 2,001,463             | 2,224,998            |
|                          | =====                 | =====                |

As of September 30, 2006 there was approximately \$2.2 million of unamortized compensation expense related to outstanding options that will be recognized through the period ended September 30, 2010.

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### Note 2. Discontinued operations

On February 28, 2005, Grey Wolf completed an IPO resulting in Abraxas substantially divesting itself of its investment in Grey Wolf.

The operations of Grey Wolf, previously reported as a business segment, are reported as discontinued operations for all periods presented in the accompanying financial statements and the operating results are reflected separately from the results of continuing operations.

Income from discontinued operations for the period ended September 30, 2005 includes a gain on the disposal of Grey Wolf of \$21.8 million, less non-cash income tax of \$6.1 million, and a loss from operations, including debt retirement costs, of \$2.8 million.

### Note 3. Income Taxes

The Company records income taxes using the liability method. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax basis of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse.

For the period ended September 30, 2006, there is no current or deferred income tax expense or benefit due to losses and/or loss carryforwards and a valuation allowance which has been recorded against such benefits.

### Note 4. Long-Term Debt

Long-term debt consisted of the following:

|                                                  | September 30,<br>2006 | Dec<br>2005 |
|--------------------------------------------------|-----------------------|-------------|
|                                                  | -----                 | -----       |
| Floating rate senior secured notes due 2009..... | \$ 125,000            | \$          |
| Senior secured revolving credit facility.....    | 1,077                 |             |
|                                                  | -----                 | -----       |
|                                                  | 126,077               |             |
| Less current maturities .....                    | -                     |             |
|                                                  | -----                 | -----       |
|                                                  | \$ 126,077            | \$          |
|                                                  | =====                 | =====       |

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Floating Rate Senior Secured Notes due 2009. In connection with the October 2004 financial restructuring, Abraxas issued \$125 million in aggregate principal amount of floating rate senior secured notes due 2009. The notes will mature on December 1, 2009. Interest is payable at a per annum floating rate of six-month LIBOR plus 7.50%. The interest rate was 12.82% per annum as of September 30, 2006. The interest rate is reset semi-annually on each June 1 and December 1. Interest is payable semi-annually in arrears on June 1 and December 1 of each year.

Senior Secured Revolving Credit Facility. On October 28, 2004, Abraxas entered into an agreement for a revolving credit facility having a maximum commitment of \$15 million, which includes a \$2.5 million subfacility for letters of credit. Availability under the revolving credit facility is subject to a borrowing base consistent with normal and customary natural gas and crude oil lending transactions.

Outstanding amounts under the revolving credit facility bear interest at the prime rate announced by Wells Fargo Bank, National Association plus 1.00%. The interest rate was 9.25% per annum as of September 30, 2006.

Subject to earlier termination rights and events of default, the stated maturity date under the revolving credit facility is October 28, 2008.

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### Note 5. Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share:

|                                                                                                                                  | Three Months Ended September<br>30, |            | Nine<br>Months<br>S |
|----------------------------------------------------------------------------------------------------------------------------------|-------------------------------------|------------|---------------------|
|                                                                                                                                  | 2006                                | 2005       | 2006                |
| <b>Numerator:</b>                                                                                                                |                                     |            |                     |
| Net income before effect of discontinued operations.....                                                                         | \$ 589                              | \$ 3,783   | \$ 2,7              |
| Discontinued operations.....                                                                                                     | -                                   | -          |                     |
| Net earnings available to common stockholders..                                                                                  | 589                                 | 3,783      | 2,7                 |
| <b>Denominator:</b>                                                                                                              |                                     |            |                     |
| Denominator for basic earnings per share -<br>Weighted-average shares.....                                                       | 42,584,045                          | 40,962,427 | 42,550,0            |
| Effect of dilutive securities:                                                                                                   |                                     |            |                     |
| Stock options and warrants.....                                                                                                  | 1,326,731                           | 1,870,121  | 1,494,8             |
| Dilutive potential common shares<br>Denominator for diluted earnings per share -<br>adjusted weighted-average shares and assumed |                                     |            |                     |

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|                                                    |            |    |            |    |          |
|----------------------------------------------------|------------|----|------------|----|----------|
| Conversions.....                                   | 43,910,776 |    | 42,832,548 |    | 44,044,8 |
| Basic earnings (loss) per share:                   |            |    |            |    |          |
| Net income (loss) from continuing operations ..... | \$ 0.01    | \$ | 0.09       | \$ | 0.       |
| Discontinued operations.....                       | -          |    | -          |    |          |
| Net earnings (loss) per common share - basic....   | \$ 0.01    | \$ | 0.09       | \$ | 0.       |
| Diluted earnings (loss) per share:                 |            |    |            |    |          |
| Net income (loss) from continuing operations ..... | \$ 0.01    | \$ | 0.09       | \$ | 0.       |
| Discontinued operations.....                       | -          |    | -          |    |          |
| Net earnings (loss) per common share - basic....   | \$ 0.01    | \$ | 0.09       | \$ | 0.       |

Note 6. Hedging Program and Derivatives

On January 1, 2001, the Company adopted SFAS 133 "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133) as amended by SFAS 137 "Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB 133" and SFAS 138 "Accounting for Certain Derivative Instruments and Certain Hedging Activities". Under SFAS 133, all derivative instruments are recorded on the balance sheet at fair value. If the derivative does not qualify as a hedge or is not designated as a hedge, the gain or loss on the derivative is recognized currently in earnings. To qualify for hedge accounting, the derivative must qualify either as a fair value hedge, cash flow hedge or foreign currency hedge. As of September 30, 2006, the derivatives that the Company had in place were not designated as hedges and, accordingly, changes in the fair value of the derivatives are recorded in current period oil and gas revenue.

Under the terms of our revolving credit facility, we are required to maintain hedging positions on not less than 25% nor more than 75% of our projected natural gas and crude oil production for a rolling six month period.

The following table sets forth the Company's current hedge position:

| Time Period   | Notional Quantities                | Price           |
|---------------|------------------------------------|-----------------|
| November 2006 | 10,000 MMBtu of production per day | Floor of \$6.00 |
| December 2006 | 10,000 MMBtu of production per day | Floor of \$5.50 |
| January 2007  | 10,000 MMBtu of production per day | Floor of \$5.50 |
| February 2007 | 10,000 MMBtu of production per day | Floor of \$5.50 |
| March 2007    | 10,000 MMBtu of production per day | Floor of \$5.00 |
| April 2007    | 10,000 MMBtu of production per day | Floor of \$4.50 |

Note 7. Contingencies - Litigation

From time to time, the Company is involved in litigation relating to claims arising out of its operations in the normal course of business. At September 30, 2006, the Company was not engaged in any legal proceedings that are expected, individually or in the aggregate, to have a material adverse effect on its operations.

Note 8. 2005 Employee Long-Term Equity Incentive Plan

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On May 25, 2006, the stockholders of the Company approved the Abraxas Petroleum Corporation 2005 Employee Long-Term Equity Incentive Plan. The following is a summary of some of the material terms of the 2005 Employee Plan.

**Purpose.** The purpose of the 2005 Employee Plan is to employ and retain qualified and competent personnel and promote the growth and success of Abraxas by aligning the long-term interests of Abraxas' key employees with those of Abraxas' stockholders by providing an opportunity to acquire an interest in Abraxas and by providing both rewards for exceptional performance and long-term incentives for future contributions to the success of Abraxas.

**Administration and Eligibility.** The 2005 Employee Plan will be administered by the Compensation Committee of the Board of Directors and authorizes the Board to grant non-qualified stock options, incentive stock options or issue restricted stock to those persons who are employees of Abraxas.

**Shares Reserved and Awards.** The 2005 Employee Plan reserves 1,200,000 shares of Abraxas common stock, subject to adjustment following certain events, as discussed below. The maximum annual award for any one employee is 200,000 shares of Abraxas common stock. If options, as opposed to restricted stock, are awarded, the exercise share price shall be no less than 100% of the fair market value on the date of the award, unless the employee is awarded incentive stock options and at the time of the award, owns more than 10% of the voting power of all classes of stock of Abraxas. Under this circumstance, the exercise share price shall be no less than 110% of the fair market value on the date of the award. Option terms and vesting schedules are at the discretion of the Compensation Committee.

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### ABRAXAS PETROLEUM CORPORATION

#### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation

Prior to February 2005, Grey Wolf Exploration Inc. was a wholly-owned Canadian subsidiary of Abraxas. In February 2005, Grey Wolf, closed an initial public offering resulting in the divestiture of a substantial amount of our capital stock in Grey Wolf. As a result of the Grey Wolf IPO and the significant divestiture of our interest in Grey Wolf, the results of operations of Grey Wolf are reflected in our Financial Statements and in this document as "Discontinued Operations" and our remaining operations are referred to in our Financial Statements and in this document as "Continuing Operations" or "Continued Operations". Unless otherwise noted, all disclosures are for continuing operations.

The following is a discussion of our financial condition, results of operations, liquidity and capital resources. This discussion should be read in conjunction with our consolidated financial statements and the notes thereto, included in our Annual Report on Form 10-K filed for the year ended December 31, 2005.

#### Critical Accounting Policies

There have been no changes from the Critical Accounting Policies described in our Annual Report on Form 10-K for the year ended December 31, 2005.

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### General

We are an independent energy company primarily engaged in the development and production of natural gas and crude oil. Historically we have grown through the acquisition and subsequent development and exploitation of producing properties, principally through the redevelopment of old fields utilizing new technologies such as modern log analysis and reservoir modeling techniques as well as 3-D seismic surveys and horizontal drilling. As a result of these activities, we believe that we have a substantial inventory of development opportunities, which provide a basis for significant production and reserve increases. In addition, we intend to expand upon our exploitation and development activities with complementary exploration projects in our core areas of operation.

Our financial results depend upon many factors which significantly affect our results of operations including the following:

- o the sales prices of natural gas and crude oil;
- o the level of total sales volumes of natural gas and crude oil;
- o the availability of, and our ability to raise additional capital resources and provide liquidity to meet cash flow needs;
- o the level of and interest rates on borrowings; and
- o the level and success of exploitation, exploration and development activity.

Commodity Prices and Hedging Activities. Our results of operations are significantly affected by fluctuations in commodity prices. Price volatility in the natural gas market has remained prevalent in the last few years. In January 2001, our realized prices for natural gas and crude oil were at high levels. However, over the course of 2001 and the beginning of the first quarter of 2002, prices again became depressed, primarily due to the economic downturn. Beginning in March 2002, commodity prices began to increase and continued higher through December 2005. Crude oil prices have continued to remain strong during the first nine months of 2006 compared to historical levels; however natural gas prices have weakened significantly from levels during the latter part of 2005 and first quarter of 2006. If natural gas prices continue to weaken, our cash flow from operations will be adversely affected.

The table below illustrates how natural gas prices have fluctuated over the eight quarters prior to and including the quarter ended September 30, 2006 and contains the average of the last three days of NYMEX traded contracts price for

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each contract month in the quarter and the prices we realized during each quarter presented, including the impact of our hedging activities.

Natural Gas Prices by Quarter (in \$ per Mcf)  
Quarter Ended

| Dec. 31,<br>2004 | Mar. 31,<br>2005 | June 30,<br>2005 | Sept. 30,<br>2005 | Dec. 31,<br>2005 | Mar. 31,<br>2006 | June 30,<br>2006 | S |
|------------------|------------------|------------------|-------------------|------------------|------------------|------------------|---|
|------------------|------------------|------------------|-------------------|------------------|------------------|------------------|---|

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|          |        |        |         |         |          |         |         |    |
|----------|--------|--------|---------|---------|----------|---------|---------|----|
| Index    | \$6.77 | \$6.30 | \$ 6.80 | \$ 8.21 | \$ 12.85 | \$ 9.18 | \$ 6.89 | \$ |
| Realized | \$6.14 | \$5.26 | \$ 6.33 | \$ 8.15 | \$ 9.12  | \$ 6.52 | \$ 5.78 | \$ |

The NYMEX natural gas price on November 3, 2006 was \$7.88 per Mcf.

The table below illustrates how crude oil prices have fluctuated over the eight quarters prior to and including the quarter ended September 30, 2006 and contains the average of the last three days of NYMEX traded contracts price for each contract month in the quarter presented and the prices we realized during each quarter presented, including the impact of our hedging activities.

Crude Oil Prices by Quarter (in \$ per Bbl)  
Quarter Ended

|          | Dec. 31,<br>2004 | Mar. 31,<br>2005 | June 30,<br>2005 | Sept. 30,<br>2005 | Dec. 31,<br>2005 | Mar. 31,<br>2006 | June 30,<br>2006 | \$ |
|----------|------------------|------------------|------------------|-------------------|------------------|------------------|------------------|----|
| Index    | \$ 49.46         | \$ 47.33         | \$ 51.76         | \$ 60.26          | \$ 61.51         | \$ 61.53         | \$ 67.38         | \$ |
| Realized | \$ 46.81         | \$ 47.13         | \$ 49.43         | \$ 60.24          | \$ 57.18         | \$ 59.57         | \$ 66.09         | \$ |

The NYMEX crude oil price on November 3, 2006 was \$59.14 per Bbl.

We seek to reduce our exposure to price volatility by hedging a portion of our production through price floors.

Under the terms of our revolving credit facility, we are required to maintain hedging positions with respect to not less than 25% nor more than 75% of our crude oil and natural gas production, on an equivalent basis, for a rolling six-month period. We currently have the following hedges in place:

| Time Period   | Notional Quantities                | Price           |
|---------------|------------------------------------|-----------------|
| November 2006 | 10,000 MMBtu of production per day | Floor of \$6.00 |
| December 2006 | 10,000 MMBtu of production per day | Floor of \$5.50 |
| January 2007  | 10,000 MMBtu of production per day | Floor of \$5.50 |
| February 2007 | 10,000 MMBtu of production per day | Floor of \$5.50 |
| March 2007    | 10,000 MMBtu of production per day | Floor of \$5.00 |
| April 2007    | 10,000 MMBtu of production per day | Floor of \$4.50 |

At September 30, 2006, the aggregate fair market value of our hedges was approximately \$392,000.

Production Volumes. Because our proved reserves will decline as natural gas and crude oil are produced, unless we acquire additional properties containing proved reserves or conduct successful exploitation, exploration or development activities, our reserves and production will decrease. Our ability to acquire or find additional reserves in the near future will be dependent, in part, upon the amount of available funds for acquisition, exploration, exploitation and development projects.

We had capital expenditures of \$21.3 million in the first nine months of 2006. As a result of the capital spending limitations included in our previous credit agreement and our 11 1/2 notes due 2007 which were eliminated in connection with our October 2004 refinancing, we were limited for most of 2004 in our ability to replace existing production and, consequently, our production volumes decreased during 2004 and continued to decrease in the first quarter of

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2005. Beginning in the second quarter of 2005, our production volumes began to increase and have continued to increase through the first nine months of 2006.

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If crude oil and natural gas prices return to depressed levels or if our production levels decrease, our revenues, cash flow from operations and financial condition will be materially adversely affected.

**Availability of Capital.** As described more fully under "Liquidity and Capital Resources" below, our sources of capital going forward will primarily be cash from operating activities, funding under our revolving credit facility, cash on hand, and if an appropriate opportunity presents itself, proceeds from the sale of properties. We currently have approximately \$15.0 million of availability under our revolving credit facility.

**Exploitation, Exploration and Development Activity.** We believe that our high quality asset base, high degree of operational control and large inventory of drilling projects position us for future growth. Our properties are concentrated in locations that facilitate substantial economies of scale in drilling and production operations and more efficient reservoir management practices. At year end December 31, 2005 we operated 95% of the properties accounting for approximately 94% of our PV-10, giving us substantial control over the timing and incurrence of operating and capital expenditures. In addition, we had 53 proved undeveloped locations and have identified over 184 drilling and recompletion opportunities on our existing acreage, the successful development of which we believe could significantly increase our daily production and proved reserves. During the first nine months of 2006, we made capital expenditures of approximately \$21.3 million for wells in south Texas, west Texas and Wyoming. We are currently re-entering a Devonian well in west Texas and are recompleting a Wilcox well in south Texas. In the Oates SW Field, two wells drilled earlier this year have been placed on production naturally (without stimulation) to enable us to evaluate the productive capability of the wells, which will allow us to effectively design fracture stimulations. We continue to perform general well maintenance and work-overs utilizing our own work-over rigs.

Our future natural gas and crude oil production, and therefore our success, is highly dependent upon our ability to find, acquire and develop additional reserves that are profitable to produce. The rate of production from our natural gas and crude oil properties and our proved reserves will decline as our reserves are produced unless we acquire additional properties containing proved reserves, conduct successful development, exploitation and exploration activities or, through engineering studies, identify additional behind-pipe zones or secondary recovery reserves. We cannot assure you that our exploration, exploitation and development activities will result in increases in our proved reserves. In addition, approximately 52% of our total estimated proved reserves at December 31, 2005 were undeveloped. By their nature, estimates of undeveloped reserves are less certain. Recovery of such reserves will require significant capital expenditures and successful drilling operations.

**Borrowings and Interest.** At November 1, 2006, we had indebtedness of approximately \$125.0 million under the notes and \$0 under the revolving credit facility and availability of \$15.0 million. Unlike the 11 1/2% secured notes due 2007 (which were redeemed in October 2004), interest on the notes is payable in cash.

**Recent events.** On September 28, 2006 we closed on the sale of certain non-core assets located in South Texas for a total consideration of \$12 million, subject to closing adjustments. The effective date of the sale was August 1,



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2006. The non-core assets were located in the Three Rivers (Edwards) Field of Live Oak County, Texas and represented less than 2% of the Company's net proved reserves as of December 31, 2005 and approximately 3% of the Company's current daily net production at July 31, 2006. The net proceeds were used to repay outstanding indebtedness under the Company's revolving credit facility.

Outlook for 2006. As a result of final 2005 financial results and current market conditions, our operating and financial guidance for 2006 is as follows:

Production:

|                                                 |           |
|-------------------------------------------------|-----------|
| BCFE (approximately 80% gas).....               | 7.5 - 8.5 |
| Exit Rate (Mmcfe/d).....                        | 22 - 24   |
| Price Differentials (Pre Hedge):                |           |
| Gas (% Mcf).....                                | 15%       |
| Oil (\$/Bbl).....                               | 2.00      |
| Production taxes (% of Revenue).....            | 10%       |
| Direct Lease Operating Expenses (\$/ Mcfe)..... | 1.10      |
| G&A (\$/ Mcfe).....                             | 0.55      |
| Interest (\$/Mcfe).....                         | 2.00      |

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|                                                                                                                                                                                                                                   |                 |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------|
| DD&A (\$/Mcfe).....                                                                                                                                                                                                               | 1.80            |
| Capital Expenditures (\$ Millions).....                                                                                                                                                                                           | 23.0 - 25.0 (1) |
| (1) Our capital expenditures are subject to adequate cash flow from operations and availability under our revolving credit facility. For more information, please see "Liquidity Capital Resources - Capital Expenditures" below. |                 |

### Results of Operations

The following table sets forth certain of our operating data for the periods presented.

|                                               | Three Months Ended<br>September 30, |           | Nine Mo<br>Septe |
|-----------------------------------------------|-------------------------------------|-----------|------------------|
|                                               | 2006                                | 2005      | 2006             |
| Operating Revenue (in thousands):             |                                     |           |                  |
| Crude Oil Sales.....                          | \$ 3,478                            | \$ 2,699  | \$ 9,620         |
| Natural Gas Sales.....                        | 9,369                               | 11,130    | 29,022           |
| Rig Operations.....                           | 363                                 | 330       | 1,168            |
| Other.....                                    | 6                                   | 5         | 15               |
|                                               | -----                               | -----     | -----            |
|                                               | \$ 13,216                           | \$ 14,164 | \$ 39,825        |
|                                               | =====                               | =====     | =====            |
| Operating Income (in thousands) .....         |                                     |           |                  |
| Crude Oil Production (MBbls).....             | \$ 5,426                            | \$ 7,905  | \$ 16,509        |
| Natural Gas Production (MMcfs).....           | 52                                  | 45        | 150              |
| Average Crude Oil Sales Price (\$/Bbl).....   | 1,725                               | 1,366     | 4,926            |
| Average Natural Gas Sales Price (\$/Mcf)..... | \$ 66.62                            | \$ 60.24  | \$ 64.24         |
|                                               | \$ 5.43                             | \$ 8.15   | \$ 5.89          |

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Comparison of Three Months Ended September 30, 2006 to Three Months Ended September 30, 2005

Operating Revenue. During the three months ended September 30, 2006, operating revenue from natural gas and crude oil sales decreased by \$1.0 million to \$12.8 million compared to \$13.8 million during three months ended September 30, 2005. The decrease in revenue was due to a decrease in the price of natural gas during the third quarter of 2006 as compared to the same period of 2005. The decrease in revenue related to the decline in the natural gas price was partially offset by increased production and higher prices received for crude oil during the quarter. The decline in natural gas prices had a negative impact on revenue of approximately \$3.7 million. Higher natural gas production contributed \$2.0 million to revenue and increased crude oil production contributed \$494,000. The increase in the price of crude oil for the quarter ended September 30, 2006 contributed \$286,000 to revenue.

Average sales prices net of hedging cost for the quarter ended September 30, 2006 were:

- o \$66.62 per Bbl of crude oil, and
- o \$5.43 per Mcf of natural gas

Average sales prices net of hedging cost for the quarter ended September 30, 2005 were:

- o \$60.24 per Bbl of crude oil, and
- o \$8.15 per Mcf of natural gas

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Crude oil production volumes increased from 44.8 MBbls during the quarter ended September 30, 2005 to 52.2 MBbls for the same period of 2006. The increase in crude oil production volumes was primarily due to production from new wells in Wyoming which was partially offset by natural field declines. Natural gas production volumes increased 359 MMcf to 1,725 MMcf for the three months ended September 30, 2006 from 1,366 MMcf for the same period of 2005. The increase in natural gas production was primarily due to new production brought on line since the third quarter of 2005. Production from wells brought on production during and since the third quarter of 2005 contributed 793.9 MMcf and 3.7 MBbls during the third quarter of 2006 compared to 376.4 MMcf and 0.3 MBbls during the third quarter of 2005. The increase in production attributable to new wells was partially offset by natural field declines and the sale of properties in Live Oak County, Texas effective August 1, 2006. The properties sold contributed 91.0 MMcf to production during the third quarter of 2005 compared to 47.8 MMcf for the two months ended August 31, 2006.

Lease Operating Expenses ("LOE"). LOE for the three months ended September 30, 2006 were consistent with LOE for the three months ended September 30, 2005 at \$3.0 million for each period. The general increase in the industry cost of services was offset by decreased production taxes. The decline in production taxes was due to the decline in the price received for natural gas during the third quarter of 2006 as compared to the same period of 2005. Our LOE on a per Mcfe basis for the three months ended September 30, 2006 decreased to \$1.44 compared to \$1.84 for the same period of 2005. The decrease in the per Mcfe rate was primarily due to increased production volumes during the quarter ended September 30, 2006 as compared to 2005.

General and Administrative ("G&A") Expenses. G&A expenses excluding stock-based compensation decreased to \$844,000 for the quarter ended September 30, 2006 from \$953,000 for the same period of 2005. The decrease in G&A expense

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was primarily due to lower professional fees in the third quarter of 2006 as compared to the same period of 2005. G&A expense on a per Mcfe basis was \$0.41 for the third quarter of 2006 compared to \$0.58 for the same period of 2005. The per Mcfe decrease was attributable to lower G&A expense as well as higher production volumes during the third quarter of 2006 as compared to the same period of 2005.

**Stock-based Compensation.** In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment". SFAS No. 123R is a revision of SFAS No. 123, "Accounting for Stock Based Compensation", and supersedes APB 25. Among other items, SFAS 123R eliminates the use of APB 25 and the intrinsic value method of accounting, and requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements.

The Company adopted SFAS 123R in the fourth quarter of 2005 using the "modified retrospective method". Under the "modified retrospective method", entities are permitted to restate financial statements of previous periods based on proforma disclosures made in accordance with SFAS 123. This standard requires the cost of all share-based payments, including stock options, to be measured at fair value on the grant date and recognized in the statement of operations. In accordance with this standard, all periods prior to January 1, 2005 were restated to reflect the impact of the standard as if it had been adopted on January 1, 1995, the original effective date of SFAS No. 123, "Accounting for Stock-Based Compensation". Also in accordance with the standard, the amounts that are reported in the statement of operations for the restated periods are the pro forma amounts previously disclosed under SFAS No. 123.

As a result of the retrospective adoption of SFAS 123R, the expenses previously recognized under the rules of variable accounting were reversed and a compensation expense measured according to SFAS 123R was recorded. As a result, we recognized stock-based compensation expense of \$207,000 during the third quarter of 2006 as a result of the adoption of this accounting change compared to \$16,000 in 2005, as adjusted. Stock-based compensation expense is included as a component of G&A expense in the accompanying financial statements. The increase in stock-based compensation expense for the three months ended September 30, 2006 over the same period of 2005 was due to new options granted during the latter part of 2005 and the first part of 2006 and the increase in the calculated fair value of these grants due to higher option prices as a result of the increase in the price of our Common stock over previous options.

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We currently utilize a standard option pricing model (i.e., Black-Scholes) to measure the fair value of stock options granted to employees. While SFAS 123R permits entities to continue to use such a model, the standard also permits the use of a more complex binomial, or "lattice" model. Based upon research done by us on the alternative models available to value option grants, and in conjunction with the type and number of stock options expected to be issued in the future, we have determined that we will continue to use the Black-Scholes model for option valuation as of the current time

**Depreciation, Depletion and Amortization("DD&A") Expenses.** DD&A expense increased to \$3.6 million for the three months ended September 30, 2006 from \$2.1 million for the same period of 2005. The increase in DD&A was primarily due to increased production volumes in the third quarter of 2006 as compared to the same period of 2005 as well as an increase in projected future development cost in 2006 as compared to 2005. Our DD&A on a per Mcfe basis for the quarter ended September 30, 2006 was \$1.78 per Mcfe as compared to \$1.29 in 2005. The increase in the per Mcfe rate was due to higher production volumes in the quarter ended September 30, 2006 as compared to 2005 as well as a increased base due to the

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increase in projected future development cost in 2006 as compared to 2005.

**Interest Expense.** Interest expense increased to \$4.4 million for the third quarter of 2006 compared to \$3.7 million for the same period of 2005. The increase in interest expense was due to an increase in our interest rate on our floating rate senior secured notes and our senior revolving credit facility as well as an increase in the amount borrowed under our revolving credit facility.

**Income taxes.** There is no current or deferred income tax expense or benefit due to losses or loss carryforwards and valuation allowance which has been recorded against such benefits.

Comparison of Nine Months Ended September 30, 2006 to Nine Months Ended September 30, 2005

**Operating Revenue.** During the nine months ended September 30, 2006, operating revenue from natural gas and crude oil sales increased by \$7.9 million to \$38.6 million as compared to \$30.7 million in the nine months ended September 30, 2005. The increase in revenue was primarily due to higher production volumes during the first nine months of 2006 as compared to the same period of 2005 which was partially offset by a decrease in natural gas prices. Increased natural gas production volumes contributed \$10.2 million and increased crude oil production contributed \$237,000 to revenue. The decline in the price of natural gas during the nine months ended September 30, 2006 had a negative impact on revenue of \$4.2 million which was partially offset by an increase in the realized crude oil price during the period. Increased crude oil prices contributed \$1.8 million to revenue during the period.

Average sales prices net of hedging cost for the nine months ended September 30, 2006 were:

- o \$64.24 per Bbl of crude oil, and
- o \$5.89 per Mcf of natural gas

Average sales prices net of hedging cost for the nine months ended September 30, 2005 were:

- o \$51.95 per Bbl of crude oil, and
- o \$6.75 per Mcf of natural gas

Crude oil production volumes increased slightly to 149.8 MBbls during the nine months ended September 30, 2006 from 145.2 MBbls for the same period of 2005. The increase in crude oil production volumes was primarily due to production from new wells in Wyoming and south Texas, which was partially offset by natural field declines. Natural gas production volumes increased by 1,499 MMcf to 4,926 MMcf for the nine months ended September 30, 2006 from 3,427 MMcf for the same period of 2005. Production from wells brought on to production during and since the third quarter of 2005 contributed 2,223 MMcf and 5.2 MBbls during the nine months ended September 30, 2006 compared to 485.0 MMcf and 0.4 MBbls during the same period of 2005. The increase in production attributable to new wells was partially offset by natural field declines.

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**Lease Operating Expenses.** LOE for the nine months ended September 30, 2006 increased to \$8.5 million from \$7.8 million for the same period of 2005. The increase was primarily due to a general increase in the cost of field services. Our LOE on a per Mcfe basis for the nine months ended September 30, 2006 decreased to \$1.45 compared to \$1.82 for the same period of 2005. The decrease in the per Mcfe rate was primarily due to increased production volumes in 2006 as compared to 2005.

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G&A Expenses. G&A expenses, excluding stock-based compensation decreased to \$2.9 million for the first nine months of 2006 from to \$3.0 million for the first nine months of 2005. The decrease in G&A expense was primarily due to a decrease in professional fees. G&A expense on a per Mcfe basis was \$0.50 for the first nine months of 2006 compared to \$0.70 for the same period of 2005. The per Mcfe decrease was primarily attributable to higher production volumes in 2006.

Stock-based Compensation. In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment". SFAS No. 123R is a revision of SFAS No. 123, "Accounting for Stock Based Compensation", and supersedes APB 25. Among other items, SFAS 123R eliminates the use of APB 25 and the intrinsic value method of accounting, and requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements.

The Company adopted SFAS 123R in the fourth quarter of 2005 using the "modified prospective method". Under the "modified retrospective method", entities are permitted to restate financial statements of previous periods based on proforma disclosures made in accordance with SFAS 123. This standard requires the cost of all share-based payments, including stock options, to be measured at fair value on the grant date and recognized in the statement of operations. In accordance with this standard, all periods prior to January 1, 2005 were restated to reflect the impact of the standard as if it had been adopted on January 1, 1995, the original effective date of SFAS No. 123, "Accounting for Stock-Based Compensation". Also in accordance with the standard, the amounts that are reported in the statement of operations for the restated periods are the pro forma amounts previously disclosed under SFAS No. 123.

As a result of the retrospective adoption of SFAS 123R, the expenses previously recognized under the rules of variable accounting were reversed and a compensation expense measured according to SFAS 123R was recorded. As a result, we recognized stock-based compensation expense of \$578,000 during the nine months ended September 30, 2006 as a result of the adoption of this accounting change compared to \$57,000 in 2005, as adjusted. Stock-based compensation expense is included as a component of G&A expense in the accompanying financial statements. The increase in stock-based compensation expense for the nine months ended September 30, 2006 over the same period of 2005 was due to new options granted during the latter part of 2005 and the first nine months of 2006 and the increase in the calculated fair value of these grants due to higher option prices as a result of the increase in the price of our Common stock over previous options.

We currently utilize a standard option pricing model (i.e., Black-Scholes) to measure the fair value of stock options granted to employees. While SFAS 123R permits entities to continue to use such a model, the standard also permits the use of a more complex binomial, or "lattice" model. Based upon research done by us on the alternative models available to value option grants, and in conjunction with the type and number of stock options expected to be issued in the future, we have determined that we will continue to use the Black-Scholes model for option valuation as of the current time.

DD&A Expenses. DD&A expense increased to \$10.8 million for the nine months ended September 30, 2006 from \$5.6 million for the same period of 2005. The increase in DD&A was primarily due to increased production volumes in the nine months of 2006 as compared to the same period of 2005 as well as an increase in projected future development cost in 2006 as compared to 2005. Our DD&A on a per Mcfe basis for the nine months ended September 30, 2006 was \$1.85 per Mcfe as compared to \$1.31 in 2005. This increase was the result of higher production volumes and the increase in projected future development cost in 2006 as compared to 2005.

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Interest Expense. Interest expense increased to \$12.5 million for the first nine months of 2006 compared to \$10.2 million for the same period of 2005. The

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increase in interest expense was due to an increase in our interest rate on our floating rate senior secured notes and our senior secured revolving credit facility as well as an increase in the amount borrowed under our revolving credit facility.

Income taxes. There is no current or deferred income tax expense or benefit due to losses or loss carryforwards and valuation allowance which has been recorded against such benefits.

### Liquidity and Capital Resources

General. The natural gas and crude oil industry is a highly capital intensive and cyclical business. Our capital requirements are driven principally by our obligations to service debt and to fund the following costs:

- o the development of existing properties, including drilling and completion costs of wells;
- o acquisition of interests in natural gas and crude oil properties; and
- o production and transportation facilities.

The amount of capital expenditures we are able to make has a direct impact on our ability to increase cash flow from operations, and, thereby, will directly affect our ability to service our debt obligations and to continue to grow the business through the development of existing properties and the acquisition of new properties.

Our sources of capital going forward will primarily be cash from operating activities, funding under our revolving credit facility, cash on hand, and if an appropriate opportunity presents itself, proceeds from the sale of properties. However, under the terms of the notes, proceeds of optional sales of our assets that are not timely reinvested in new natural gas and crude oil assets will be required to be used to reduce indebtedness and proceeds of mandatory sales must be used to repay or redeem indebtedness. All of the proceeds from the sale of the Live Oak County, Texas properties in September 2006 were used to re-pay indebtedness under our revolving credit facility.

Working Capital (Deficit). At September 30, 2006, we had current assets of \$8.4 million and current liabilities of \$11.6 million resulting in a working capital deficit of approximately \$3.2 million. This compares to a working capital deficit of \$4.9 million at December 31, 2005. Current liabilities at September 30, 2006 consisted of trade payables of \$2.0 million, revenues due third parties of \$2.6 million, accrued interest of \$5.5 million and other accrued liabilities of \$1.5 million.

Capital expenditures. The table below sets forth the components of our capital expenditures on a historical basis for the nine months ended September 30, 2006 and 2005.

| Nine Months Ended<br>September 30, |      |
|------------------------------------|------|
| -----                              |      |
| 2006                               | 2005 |

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| Expenditure category (in thousands): | -----     | -----     |
|--------------------------------------|-----------|-----------|
| Development.....                     | \$ 21,141 | \$ 28,350 |
| Facilities and other.....            | 149       | 254       |
|                                      | -----     | -----     |
| Total.....                           | \$ 21,290 | \$ 28,604 |
|                                      | =====     | =====     |

We have no material long-term capital commitments and are consequently able to adjust the level of our expenditures as circumstances dictate. The level of capital expenditures will vary during future periods depending on market conditions and other related economic factors effecting cash flow.

At the start of 2006, we anticipated making capital expenditures, primarily for the development of our current properties, of approximately \$40.0 million which was based upon the anticipated amount of our cash flow from operations and availability under our revolving credit facility. As natural gas prices have decreased during the first nine months of 2006, our cash flow from operations has not reached the levels that we had anticipated. As a result we will spend less than the original budget of \$40.0 million. We expect to spend between \$23 million and \$25 million on capital expenditures for 2006. Our ability to make all of our budgeted capital expenditures will also be subject to availability of drilling rigs and other field equipment and services. Our capital expenditures could also include expenditures for acquisition of producing properties if such

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opportunities arise, but we currently have no agreements, arrangements or undertakings regarding any material acquisitions. Should the prices of natural gas continue to decline, crude oil prices begin to decline, or if our costs of operations increase as a result of the scarcity of drilling rigs or if our production volumes decrease, our cash flow from operations will decrease which may result in a further reduction of the capital expenditures budget.

Sources of Capital. The net funds provided by and/or used in each of the operating, investing and financing activities, all relating to continuing operations, are summarized in the following table:

|                                                     | Nine Months Ended<br>September 30, |                        |
|-----------------------------------------------------|------------------------------------|------------------------|
|                                                     | -----<br>2006<br>-----             | -----<br>2005<br>----- |
| Net cash provided by operating activities           | \$ 13,290                          | \$ 14,769              |
| Net cash used in investing activities               | (9,421)                            | (28,604)               |
| Net cash (used in) provided by financing activities | (2,882)                            | 15,134                 |
|                                                     | -----                              | -----                  |
| Total                                               | \$ 987                             | \$ 1,299               |
|                                                     | =====                              | =====                  |

Operating activities during the nine months ended September 30, 2006 provided \$13.3 million in cash compared to providing \$14.8 million in the same period in 2005. Net income plus non-cash expense items and net changes in operating assets and liabilities accounted for most of these funds. Financing activities used \$2.9 million for the first nine months of 2006 compared to

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providing approximately \$15.1 million for the first nine months of 2005. For the nine months ended September 30, 2006, proceeds from long-term borrowing provided \$18.3 million while payments on long-term borrowings used \$14.9 million. Proceeds from long-term borrowings provided \$17.7 million in 2005 while payments on long-term borrowings used \$14.3 million in 2005. Proceeds from an equity offering in July 2005 provided \$11.3 million for the nine months ended September 30, 2005. Investing activities used \$9.4 million for the nine months ended September 30, 2006. Capital expenditures of \$21.3 million were offset by proceeds from the sale of non-core oil and gas properties of \$11.9 million. Investing activities used \$28.6 million for the nine months ended September 30, 2005. Expenditures during the nine months ended September 30, 2006 and 2005 were primarily for the development of existing properties.

Future Capital Resources. We currently have three principal sources of liquidity going forward: (i) cash from operating activities, (ii) funding under our revolving credit facility, and (iii) if an appropriate opportunity presents itself, the sale of producing properties. If these sources of liquidity do not prove to be sufficient, we may also issue additional shares of equity securities although we may not be able to complete equity financings on terms acceptable to us, if at all. Covenants under the indenture for the notes and the revolving credit facility restrict our use of cash from operating activities, cash on hand and any proceeds from asset sales. Under the terms of the notes, proceeds of optional sales of our assets that are not timely reinvested in new natural gas and crude oil assets will be required to be used to reduce indebtedness and proceeds of mandatory sales must be used to redeem indebtedness. The terms of the notes and the revolving credit facility also substantially restrict our ability to:

- o incur additional indebtedness;
- o grant liens;
- o pay dividends or make certain other restricted payments;
- o merge or consolidate with any other entity; or
- o sell, assign, transfer, lease, convey or otherwise dispose of all or substantially all of our assets.

Our cash flow from operations depends heavily on the prevailing prices of natural gas and crude oil and our production volumes of natural gas and crude oil. Although we have hedged a portion of our natural gas and crude oil production and will continue this practice as required pursuant to the revolving credit facility, future natural gas and crude oil price declines would have a material adverse effect on our overall results, and therefore, our liquidity. Falling natural gas and crude oil prices could also negatively affect our ability to raise capital on terms favorable to us or at all.

Our cash flow from operations will also depend upon the volume of natural gas and crude oil that we produce. Unless we otherwise expand reserves, our production volumes may decline as reserves are produced. Due to sales of properties in 2002 and 2003, the divestiture of Grey Wolf during the first quarter of 2005, and restrictions on capital expenditures under the terms of our 11 1/2% secured notes due 2007 (which were refinanced in October 2004), we now have significantly reduced reserves and production as compared with pre-2003 levels. In the future, if an appropriate opportunity presents itself, we may sell additional properties, which could further reduce our production volumes. To offset the loss in production volumes resulting from natural field declines and sales of producing properties, we must conduct successful, exploitation,



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exploration and development activities, acquire additional producing properties or identify additional behind-pipe zones or secondary recovery reserves. We believe our numerous drilling opportunities will allow us to increase our production volumes; however, our drilling activities are subject to numerous risks, including the risk that no commercially productive natural gas or crude oil reservoirs will be found. The risk of not finding commercially productive reservoirs will be compounded by the fact that 52% of our total estimated proved reserves at December 31, 2005 were undeveloped. During the first nine months of 2006, we expended approximately \$21.3 million for wells in south Texas, west Texas and Wyoming. We are currently re-entering a Devonian well in west Texas and are recompleting a Wilcox well in south Texas. In the Oates SW Field, two wells drilled earlier this year have been placed on production naturally (without stimulation) to enable us to evaluate the productive capability of the wells which will allow us to effectively design fracture stimulations. We continue to perform general well maintenance and work-overs utilizing our own work-over rigs. In addition, approximately 29% of our production at September 30, 2006 was from a single well in west Texas. If production from this well decreases, the volume of our production would also decrease which, in turn, would likely cause our cash flow from operations to decrease.

Our total indebtedness and cash interest expense as a result of issuing the notes and entering into the revolving credit facility require us to increase our production and cash flow from operations in order to meet our debt service requirements, as well as to fund the development of our numerous drilling opportunities. The ability to satisfy these new obligations will depend upon our drilling success as well as prevailing commodity prices.

### Contractual Obligations

We are committed to making cash payments in the future on the following types of agreements:

- o Long-term debt
- o Operating leases for office facilities

We have no off-balance sheet debt or unrecorded obligations and we have not guaranteed the debt of any other party. Below is a schedule of the future payments that we are obligated to make based on agreements in place as of September 30, 2006:

| Contractual<br>Obligations (dollars<br>in thousands) | Payments due in twelve month periods ended: |                       |                            |                            |
|------------------------------------------------------|---------------------------------------------|-----------------------|----------------------------|----------------------------|
|                                                      | Total                                       | September 30,<br>2007 | September 30,<br>2008-2009 | September 30,<br>2010-2011 |
| Long-Term Debt (1)                                   | \$ 126,077                                  | \$ -                  | \$ 1,077                   | \$ 125,000                 |
| Interest on long-term<br>debt (2)                    | 50,954                                      | 16,125                | 32,158                     | 2,671                      |
| Operating Leases (3)                                 | 589                                         | 254                   | 335                        | -                          |
| Total                                                | \$ 177,620                                  | \$ 16,379             | \$ 33,570                  | \$ 127,671                 |

(1) These amounts represent the balances outstanding under the revolving credit facility and the notes. These repayments assume that we will not draw down additional funds

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- (2) Interest expense assumes the balances of long-term debt at the end of the period and current effective interest rates.
- (3) Office lease obligations. The lease for office space for Abraxas expires in 2009

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Other obligations. We make and will continue to make substantial capital expenditures for the acquisition, exploitation, development, exploration and production of natural gas and crude oil. In the past, we have funded our operations and capital expenditures primarily through cash flow from operations, sales of properties, sales of production payments and borrowings under our bank credit facilities and other sources. Given our high degree of operating control, the timing and incurrence of operating and capital expenditures is largely within our discretion.

### Long-Term Indebtedness

|                                                  | September 30,<br>2006 | December 31,<br>2005 |
|--------------------------------------------------|-----------------------|----------------------|
| -----                                            |                       |                      |
| (In thousands)                                   |                       |                      |
| -----                                            |                       |                      |
| Floating rate senior secured notes due 2009..... | \$ 125,000            | \$ 125,000           |
| Senior secured revolving credit facility.....    | 1,077                 | 4,527                |
|                                                  | -----                 | -----                |
|                                                  | 126,077               | 129,527              |
| Less current maturities .....                    | -                     | -                    |
|                                                  | -----                 | -----                |
|                                                  | \$ 126,077            | \$ 129,527           |
|                                                  | =====                 | =====                |

Floating Rate Senior Secured Notes due 2009. In connection with the October 2004 financial restructuring, Abraxas issued \$125 million in principal aggregate amount of Floating Rate Senior Secured Notes due 2009. The notes will mature on December 1, 2009 and began accruing interest from the date of issuance, October 28, 2004 at a per annum floating rate of six-month LIBOR plus 7.50%. The current interest rate is 12.82% per annum. The interest rate is reset semi-annually on each June 1 and December 1. Interest is payable semi-annually in arrears on June 1 and December 1 of each year.

The notes rank equally among themselves and with all of our unsubordinated and unsecured indebtedness, including our credit facility and senior in right of payment to our existing and future subordinated indebtedness.

Each of our subsidiaries, Eastside Coal Company, Inc., Sandia Oil & Gas Corporation, Sandia Operating Corp., Wamsutter Holdings, Inc. and Western Associated Energy Corporation (collectively, the "Subsidiary Guarantors"), has unconditionally guaranteed, jointly and severally, the payment of the principal, premium and interest on the notes on a senior secured basis. In addition, any other subsidiary or affiliate of ours, that in the future guarantees any other indebtedness with us, or our restricted subsidiaries, will also be required to guarantee the notes.

The notes and the Subsidiary Guarantors' guarantees thereof, together with our revolving credit facility and the Subsidiary Guarantors' guarantees thereof, are secured by shared first priority perfected security interests, subject to

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certain permitted encumbrances, in all of our and each of our restricted subsidiaries' material property and assets, including substantially all of our and their natural gas and crude oil properties and all of the capital stock (or in the case of an unrestricted subsidiary that is a controlled foreign corporation, up to 65% of the outstanding capital stock) of any entity, owned by us and our restricted subsidiaries (collectively, the "Collateral").

The notes may be redeemed, at our election, as a whole or from time to time in part, at any time after April 28, 2007, upon not less than 30 nor more than 60 days' notice to each holder of notes to be redeemed, subject to the conditions and at the redemption prices (expressed as percentages of principal amount) set forth below, together with accrued and unpaid interest and Liquidating Damages (as defined in the indenture) if any, to the applicable redemption date.

| Year                                  | Percentage |
|---------------------------------------|------------|
| From April 29, 2007 to April 28, 2008 | 104.00%    |
| From April 29, 2008 to April 28, 2009 | 102.00%    |
| After April 28, 2009                  | 100.00%    |

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Prior to April 28, 2007, we may redeem up to 35% of the aggregate original principal amount of the notes using the net proceeds of one or more equity offerings, in each case at the redemption price equal to the product of (i) the principal amount of the notes being so redeemed and (ii) a redemption price factor of 1.00 plus the per annum interest rate on the notes (expressed as a decimal) on the applicable redemption date plus accrued and unpaid interest to the applicable redemption date, provided certain conditions are also met.

If we experience specific kinds of change of control events, each holder of notes may require us to repurchase all or any portion of such holder's notes at a purchase price equal to 101% of the principal amount of the notes, plus accrued and unpaid interest to the date of repurchase.

The indenture governing the notes contains covenants that, among other things, limit our ability to:

- o incur or guarantee additional indebtedness and issue certain types of preferred stock or redeemable stock;
- o transfer or sell assets;
- o create liens on assets;
- o pay dividends or make other distributions on capital stock or make other restricted payments, including repurchasing, redeeming or retiring capital stock or subordinated debt or making certain investments or acquisitions;
- o engage in transactions with affiliates;
- o guarantee other indebtedness;
- o permit restrictions on the ability of our subsidiaries to distribute or lend money to us;
- o cause a restricted subsidiary to issue or sell its' capital stock; and

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- o consolidate, merge or transfer all or substantially all of the consolidated assets of our and our restricted subsidiaries.

The indenture also contains customary events of default, including nonpayment of principal or interest, violations of covenants, cross default and cross acceleration to certain other indebtedness, including our revolving credit facility, bankruptcy, and material judgments and liabilities.

Senior Secured Revolving Credit Facility. On October 28, 2004, we entered into an agreement for a revolving credit facility having a maximum commitment of \$15 million, which includes a \$2.5 million subfacility for letters of credit. Availability under the revolving credit facility is subject to a borrowing base consistent with normal and customary natural gas and crude oil lending transactions.

Outstanding amounts under the revolving credit facility bear interest at the prime rate announced by Wells Fargo Bank, National Association plus 1.00%. The current interest rate is 9.25% per annum. Subject to earlier termination rights and events of default, the stated maturity date under the revolving credit facility is October 28, 2008.

We are permitted to terminate the revolving credit facility, and under certain circumstances, may be required, from time to time, to permanently reduce the lenders' aggregate commitment under the revolving credit facility. Such termination and each such reduction is subject to a premium equal to the percentage listed below multiplied by the lenders' aggregate commitment under the revolving credit facility, or, in the case of partial reduction, the amount of such reduction.

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| Year | % Premium |
|------|-----------|
| 1    | 1.5       |
| 2    | 1.0       |
| 3    | 0.5       |
| 4    | 0.0       |

Each of our current subsidiaries has guaranteed, and each of our future restricted subsidiaries will guarantee, our obligations under the revolving credit facility on a senior secured basis. In addition, any other subsidiary or affiliate of ours, that in the future guarantees any of our other indebtedness or of our restricted subsidiaries will be required to guarantee our obligations under the revolving credit facility. Obligations under the revolving credit facility are secured, together with the notes, by a shared first priority perfected security interest, subject to certain permitted encumbrances, in all of our and each of our restricted subsidiaries' material property and assets, including substantially all of our and their natural gas and crude oil properties and all of the capital stock (or in the case of an unrestricted subsidiary that is a controlled foreign corporation, up to 65% of the outstanding capital stock) in any entity, owned by us and our restricted subsidiaries.

Under the revolving credit facility, we are subject to customary covenants, including certain financial covenants and reporting requirements. The revolving credit facility requires us to maintain a minimum net cash interest coverage and also requires us to enter into hedging agreements on not less than 25% or more than 75% of our projected natural gas and crude oil production.

In addition to the foregoing and other customary covenants, the revolving credit facility contains a number of covenants that, among other things,

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restrict Abraxas' ability to:

- o incur or guarantee additional indebtedness and issue certain types of preferred stock or redeemable stock;
- o transfer or sell assets;
- o create liens on assets;
- o pay dividends or make other distributions on capital stock or make other restricted payments, including repurchasing, redeeming or retiring capital stock or subordinated debt or making certain investments or acquisitions;
- o engage in transactions with affiliates;
- o guarantee other indebtedness;
- o make any change in the principal nature of our business;
- o prepay, redeem, purchase or otherwise acquire any of our or our restricted subsidiaries' indebtedness;
- o permit a change of control;
- o directly or indirectly make or acquire any investment;
- o cause a restricted subsidiary to issue or sell our capital stock; and
- o consolidate, merge or transfer all or substantially all of the consolidated assets of Abraxas and our restricted subsidiaries.

The revolving credit facility also contains customary events of default, including nonpayment of principal or interest, violations of covenants, cross default and cross acceleration to certain other indebtedness, bankruptcy and material judgments and liabilities, and is subject to an Intercreditor, Security and Collateral Agency Agreement, which specifies the rights of the parties thereto to the proceeds from the Collateral.

Intercreditor Agreement. The holders of the notes, together with the lenders under our credit facility, are subject to an Intercreditor, Security and Collateral Agency Agreement, which specifies the rights of the parties thereto to the proceeds from the Collateral. The Intercreditor Agreement, among other things, (i) creates security interests in the Collateral in favor of a collateral agent for the benefit of the holders of the notes and the credit

facility lenders and (ii) governs the priority of payments among such parties upon notice of an event of default under the Indenture or the credit facility.

So long as no such event of default exists, the collateral agent will not collect payments under the new credit facility documents or the indenture governing the notes and other note documents (collectively, the "Secured Documents"), and all payments will be made directly to the respective creditor under the applicable Secured Document. Upon notice of an event of default and for so long as an event of default exists, payments to each credit facility lender and holder of the notes from us and our current subsidiaries and proceeds from any disposition of any collateral, will, subject to limited exceptions, be

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collected by the collateral agent for deposit into a collateral account and then distributed as provided in the following paragraph.

Upon notice of any such event of default and so long as an event of default exists, funds in the collateral account will be distributed by the collateral agent generally in the following order of priority:

first, to reimburse the collateral agent for expenses incurred in protecting and realizing upon the value of the Collateral;

second, to reimburse the credit facility administrative agent and the trustee, on a pro rata basis, for expenses incurred in protecting and realizing upon the value of the Collateral while any of these parties was acting on behalf of the Control Party (as defined below);

third, to reimburse the credit facility administrative agent and the trustee, on a pro rata basis, for expenses incurred in protecting and realizing upon the value of the Collateral while any of these parties was not acting on behalf of the Control Party;

fourth, to pay all accrued and unpaid interest (and then any unpaid commitment fees) under the credit facility;

fifth, if, the collateral coverage value of three times the outstanding obligations under the credit facility would be met after giving effect to any payment under this clause "fifth," to pay all accrued and unpaid interest on the notes;

sixth, to pay all outstanding principal of (and then any other unpaid amounts, including, without limitation, any fees, expenses, premiums and reimbursement obligations) the credit facility;

seventh, to pay all accrued and unpaid interest on the notes (if not paid under clause "fifth");

eighth, to pay all outstanding principal of (and then any other unpaid amounts, including, without limitation, any premium with respect to) the notes; and

ninth, to pay each credit facility lender, holder of the notes, and other secured party, on a pro rata basis, all other amounts outstanding under the credit facility and the notes.

To the extent there exists any excess monies or property in the collateral account after all of ours and our subsidiaries' obligations under the credit facility, the indenture and the notes are paid in full, the collateral agent will be required to return such excess to us.

The collateral agent will act in accordance with the Intercreditor Agreement and as directed by the "Control Party" which for purposes of the Intercreditor Agreement is the holders of the notes and the credit facility lenders, acting as a single class, by vote of the holders of a majority of the aggregate principal amount of outstanding obligations under the notes and the credit facility.

The Intercreditor Agreement provides that the lien on the assets constituting part of the Collateral that is sold or otherwise disposed of in accordance with the terms of each Secured Document may be released if (i) no default or event of default exists under any of the Secured Documents, (ii) we have delivered an officers' certificate to each of the collateral agent, the trustee, the credit facility administrative agent certifying that the proposed sale or other disposition of assets is either permitted or required by, and is

in accordance with the provisions of, the applicable Secured Documents and (iii) the collateral agent has acknowledged such certificate.

The Intercreditor Agreement provides for the termination of security interests on the date that all obligations under the Secured Documents are paid in full.

#### Hedging Activities

Our results of operations are significantly affected by fluctuations in commodity prices and we seek to reduce our exposure to price volatility by hedging our production through commodity derivative instruments. Under the revolving credit facility, we are required to maintain hedge positions on not less than 25% nor more than 75% of our projected oil and gas production for a rolling six month period.

#### Net Operating Loss Carryforwards

At December 31, 2005, we had \$190.0 million of net operating loss carryforwards for U.S. tax purposes. These loss carryforwards will expire through 2025 if not utilized.

Uncertainties exist as to the future utilization of the operating loss carryforwards under the criteria set forth under FASB Statement No. 109. Therefore there is no current or deferred income tax expense or benefit due to losses and/or loss carryforwards, and a valuation allowance which has been recorded against such benefits.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk.

#### Commodity Price Risk

As an independent natural gas and crude oil producer, our revenue, cash flow from operations, other income and profitability, reserve values, access to capital and future rate of growth are substantially dependent upon the prevailing prices of natural gas, natural gas liquids and crude oil. Declines in commodity prices will materially adversely affect our financial condition, liquidity, ability to obtain financing and operating results. Lower commodity prices may reduce the amount of natural gas and crude oil that we can produce economically. Prevailing prices for such commodities are subject to wide fluctuation in response to relatively minor changes in supply and demand and a variety of additional factors beyond our control, such as global political and economic conditions. Historically, prices received for natural gas and crude oil production have been volatile and unpredictable, and such volatility is expected to continue. Most of our production is sold at market prices. Generally, if the commodity indexes fall, the price that we receive for our production will also decline. Therefore, the amount of revenue that we realize is partially determined by factors beyond our control. Assuming the production levels we attained during the nine months ended September 30, 2006, a 10% decline in natural gas, natural gas liquids and crude oil prices would have reduced our operating revenue, cash flow and net income by approximately \$3.9 million for the period.

#### Hedging Sensitivity

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On January 1, 2001, we adopted SFAS 133 as amended by SFAS 137 and SFAS 138. Under SFAS 133, all derivative instruments are recorded on the balance sheet at fair value. If the derivative does not qualify as a hedge or is not designated as a hedge, the gain or loss on the derivative is recognized currently in earnings. To qualify for hedge accounting, the derivative must qualify either as a fair value hedge, cash flow hedge or foreign currency hedge. None of the derivatives in place as of September 30, 2005 are designated as hedges. Accordingly, the change in the market value of the instrument is reflected in current oil and gas revenue.

Under the terms of the revolving credit facility, we are required to maintain hedging positions on not less than 25% nor more than 75% of our natural gas and crude oil production for a rolling six month period.

See "General - Commodity Prices and Hedging Activities" for a summary of our current hedge positions.

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### Interest Rate Risk

At September 30, 2006 we had \$125.0 million in outstanding indebtedness under the floating rate senior secured notes due 2009. The notes bear interest at a per annum rate of six-month LIBOR plus 7.5%. The rate is redetermined on June 1 and December 1 of each year, beginning June 1, 2005. The current rate on the notes is 12.82%. For every percentage point that the LIBOR rate rises, our interest expense would increase by approximately \$1.3 million on an annual basis. At September 30, 2006, we had \$1.1 million of outstanding indebtedness under our revolving credit facility. Interest on this facility accrues at the prime rate announced by Wells Fargo Bank plus 1.00%. For every percentage point increase in the announced prime rate, our interest expense would increase by approximately \$11,000 on an annual basis.

### Item 4. Controls and Procedures.

As of the end of the period covered by this report, our Chief Executive Officer and Chief Financial Officer carried out an evaluation of the effectiveness of Abraxas' "disclosure controls and procedures" (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) and concluded that the disclosure controls and procedures were effective and designed to ensure that material information relating to Abraxas and our consolidated subsidiaries which is required to be included in our periodic Securities and Exchange Commission filings would be made known to them by others within those entities. There were no changes in our internal controls over financial reporting during the period covered by this report that could materially affect, or are reasonably likely to materially affect, our financial reporting.

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ABRAXAS PETROLEUM CORPORATION

PART II  
OTHER INFORMATION

### Item 1. Legal Proceedings.



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There have been no changes in legal proceedings from that described in the Company's Annual Report of Form 10-K for the year ended December 31, 2005, and in Note 7 in the Notes to Condensed Consolidated Financial Statements contained in Part I of this report on Form 10-Q.

### Item 1A. Risk Factors.

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing Abraxas. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

### 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) Exhibits

Exhibit 31.1 Certification - Robert L.G. Watson, CEO

Exhibit 31.2 Certification - Chris E. Williford, CFO

Exhibit 32.1 Certification pursuant to 18 U.S.C. Section 1350 - Robert L.G. Watson, CEO

Exhibit 32.2 Certification pursuant to 18 U.S.C. Section 1350 - Chris E. Williford, CFO

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ABRAXAS PETROLEUM CORPORATION

SIGNATURES

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

Date: November 6, 2006

By:/s/ Robert L.G. Watson

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ROBERT L.G. WATSON,  
President and Chief  
Executive Officer

Date: November 6, 2006

By:/s/ Chris E. Williford

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CHRIS E. WILLIFORD,  
Executive Vice President and  
Principal Accounting Officer