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ABRAXAS PETROLEUM CORP

Form 424B3

August 17, 2004

Prospectus Supplement No. 1
to Prospectus dated August 3, 2004.

Filed Pursuant to Rule 424(b)(3)
Registration Statement No. 333-103027

ABRAXAS PETROLEUM CORPORATION

11 1/2% Secured Notes due 2007, Series A

6,592,699 Shares of Abraxas Common Stock

We are supplementing the prospectus dated August 3, 2004, to add certain information contained in our Quarterly Report on Form 10-Q for the quarter ended June 30, 2004. This prospectus supplement is not complete without, and may not be delivered or utilized except in connection with, the prospectus dated August 3, 2004, with respect to the securities described above, including any amendments or supplements thereto.

This prospectus supplement, together with the prospectus listed above, is to be used by certain holders of the above-referenced securities or by their transferees, pledges, donees or their successors in connection with the offer and sale of the above referenced securities. This prospectus supplement should be read in conjunction with the prospectus dated August 3, 2004 that is to be delivered with this prospectus supplement. All capitalized terms used but not defined in this prospectus supplement shall have the meanings given them in the prospectus dated August 3, 2004.

You should carefully consider the risk factors beginning on page 12 of the prospectus dated August 3, 2004, before making an investment in the notes or common stock.

Neither the SEC nor any state securities commission has approved or disapproved of the notes or the Abraxas common stock or determined if this prospectus supplement or the prospectus dated August 3, 2004 is accurate or complete. Any representation to the contrary is a criminal offense.

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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 when we describe what we "believe," "expect" or "anticipate" will occur or what we "intend" to do, and other similar statements), you must remember 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 headings "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 ability to raise capital;
- o economic and business conditions;
- o price and availability of alternative fuels;
- o political and economic conditions in oil producing countries, especially those in the Middle East;
- o our success in development, exploitation and exploration activities;
- o planned capital expenditures;
- o prices for crude oil and natural gas;
- o declines in our production of crude oil and natural gas;
- o our acquisition and divestiture activities;
- o results of our hedging activities; and
- o other factors discussed elsewhere in this document.

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Abraxas Petroleum Corporation Condensed Consolidated Balance Sheets (in thousands)

| | June 30, 2004 (Unaudited) | December 31, 2003 |
|------------------------------|---------------------------------|----------------------|
| | ----- | ----- |
| Assets: | | |
| Current assets: | | |
| Cash | \$ 1,491 | \$ 493 |
| Accounts receivable, net | | |
| Joint owners | 297 | 1,360 |
| Oil and gas production | 5,306 | 5,873 |
| Other | 482 | 1,090 |

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| | | |
|---|-----------|-----------|
| | ----- | ----- |
| | 6,085 | 8,323 |
| Equipment inventory | 778 | 782 |
| Other current assets | 666 | 572 |
| | ----- | ----- |
| Total current assets | 9,020 | 10,170 |
| Property and equipment: | | |
| Oil and gas properties, full cost method of accounting: | | |
| Proved | 331,732 | 325,222 |
| Unproved, not subject to amortization | 2,483 | 4,304 |
| Other property and equipment | 5,334 | 4,540 |
| | ----- | ----- |
| Total | 339,549 | 334,066 |
| Less accumulated depreciation, depletion, and amortization | 228,434 | 222,503 |
| | ----- | ----- |
| Total property and equipment - net | 111,115 | 111,563 |
| Deferred financing fees, net | 5,151 | 4,410 |
| Other assets | 294 | 294 |
| | ----- | ----- |
| Total assets | \$125,580 | \$126,437 |
| | ===== | ===== |

See accompanying notes to condensed consolidated financial statements

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

| | June 30, 2004 (Unaudited) | December 31, 2003 |
|---------------------------------------|---------------------------------|----------------------|
| | ----- | ----- |
| Liabilities and Stockholders' Deficit | | |
| Current liabilities: | | |
| Accounts payable | \$ 2,793 | \$ 6,756 |
| Oil and gas production payable | 2,905 | 2,290 |
| Accrued interest | 2,410 | 2,340 |
| Other accrued expenses | 1,698 | 1,228 |
| | ----- | ----- |
| Total current liabilities | 9,806 | 12,614 |
| Long-term debt | 192,387 | 184,649 |
| Future site restoration | 1,759 | 1,377 |
| | ----- | ----- |

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| | | |
|---|------------|------------|
| Total liabilities | 203,952 | 198,640 |
| Stockholders' deficit: | | |
| Common Stock, par value \$.01 per share- | | |
| Authorized 200,000,000 shares; issued, 36,354,066 | | |
| and 36,024,308 at June 30, 2004 and | | |
| December 31, 2003 respectively | 363 | 360 |
| Additional paid-in capital | 141,662 | 141,835 |
| Accumulated deficit | (218,885) | (213,701) |
| Receivables from stock sales | -- | (97) |
| Treasury stock, at cost, 105,898 and 165,883 shares at June | | |
| 30, 2004 and December 31, 2003 respectively | (525) | (964) |
| Accumulated other comprehensive loss | (987) | 364 |
| | ----- | ----- |
| Total stockholders' deficit | (78,372) | (72,203) |
| | ----- | ----- |
| Total liabilities and stockholders' deficit | \$ 125,580 | \$ 126,437 |
| | ===== | ===== |

See accompanying notes to condensed consolidated financial statements

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Abraxas Petroleum Corporation
Condensed Consolidated Statements of Operations
(Unaudited)
(in thousands except per share data)

| | Three Months Ended June 30, | |
|---|--------------------------------|----------|
| | 2004 | 2003 |
| | ----- | ----- |
| Revenue: | | |
| Oil and gas production revenues | \$ 12,039 | \$ 8,261 |
| Gas processing revenues | -- | -- |
| Rig revenues | 129 | 158 |
| Other | 99 | 11 |
| | ----- | ----- |
| | 12,267 | 8,430 |
| Operating costs and expenses: | | |
| Lease operating and production taxes | 3,305 | 2,066 |
| Depreciation, depletion, and amortization | 3,222 | 2,301 |
| Rig operations | 123 | 148 |
| General and administrative | 2,226 | 1,231 |
| Stock-based compensation | (2,316) | 757 |
| | ----- | ----- |

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| | | |
|--|---------|------------|
| | 6,560 | 6,503 |
| | ----- | ----- |
| Operating income (loss) | 5,707 | 1,927 |
| Other (income) expense: | | |
| Interest income | (2) | (7) |
| Interest expense | 4,268 | 3,846 |
| Amortization of deferred financing fee | 467 | 434 |
| Financing cost | 602 | -- |
| Gain on sale of foreign subsidiaries | -- | -- |
| Other | -- | -- |
| | ----- | ----- |
| | 5,335 | 4,273 |
| | ----- | ----- |
| Earnings (loss) before cumulative effect of accounting change and taxes | 372 | (2,346) |
| Cumulative effect of accounting change | -- | -- |
| Income tax (expense) benefit | -- | -- |
| | ----- | ----- |
| Net earnings (loss) | \$ 372 | \$ (2,346) |
| | ===== | ===== |
| Basic earnings (loss) per common share: | | |
| Net earnings (loss) | \$ 0.01 | \$ (0.07) |
| Cumulative effect of accounting change | -- | -- |
| | ----- | ----- |
| Net earnings (loss) per common share - basic | \$ 0.01 | \$ (0.07) |
| | ===== | ===== |
| Diluted earnings (loss) per common share: | | |
| Net earnings (loss) | \$ 0.01 | \$ (0.07) |
| Cumulative effect of accounting change | -- | -- |
| | ----- | ----- |
| Net earnings (loss) per common share - diluted | \$ 0.01 | \$ (0.07) |
| | ===== | ===== |

See accompanying notes to condensed consolidated financial statements

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Abraxas Petroleum Corporation

Condensed Consolidated Statements of Cash Flows
(Unaudited)
(in thousands)

Six Months Ended
June 30,

2004 2003

Operating Activities

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| | | |
|---|----------------|-----------------|
| Net earnings (loss) | \$ (5,185) | \$ 60,356 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation, depletion, and amortization | 6,257 | 5,443 |
| Deferred income tax (benefit) expense | -- | 377 |
| Amortization of deferred financing fees | 912 | 811 |
| Accretion of future sit restoration | 336 | 439 |
| Non-cash interest and financing cost | 5,966 | 3,115 |
| Stock-based compensation | (253) | 792 |
| Gain on sale of foreign subsidiaries | -- | (66,960) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 2,301 | (314) |
| Equipment inventory | 4 | 142 |
| Other | (169) | 597 |
| Accounts payable and accrued expenses | (2,861) | (838) |
| | <u>7,308</u> | <u>3,960</u> |
| Net cash provided by operating activities | | |
| Investing Activities | | |
| Capital expenditures, including purchases and development of properties | (7,085) | (9,990) |
| Proceeds from sale of foreign subsidiaries | -- | 86,553 |
| | <u>(7,085)</u> | <u>76,563</u> |
| Net cash (used in) provided by investing activities | | |
| Financing Activities | | |
| Proceeds from long-term borrowings | 5,372 | 47,293 |
| Payments on long-term borrowings | (3,600) | (128,315) |
| Proceeds from stock sale receivable | 98 | -- |
| Issuance of stock for compensation | 328 | -- |
| Deferred financing fees | (1,653) | (2,604) |
| Exercise of stock options | 193 | 19 |
| | <u>738</u> | <u>(83,607)</u> |
| Net cash provided by (used in) financing activities | | |
| Effect of exchange rate changes on cash | 37 | 301 |
| | <u>998</u> | <u>(2,783)</u> |
| Increase (decrease) in cash | | |
| Cash, at beginning of period | 493 | 4,882 |
| | <u>1,491</u> | <u>2,099</u> |
| Cash, at end of period | \$ | \$ |
| Supplemental disclosure of cash flow information: | | |
| Interest paid | \$ 2,321 | \$ 3,932 |
| Non-cash items: | | |
| Future site restoration | \$ 147 | \$ (3,068) |

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, 2003. 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 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 six months ended June 30, 2004 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 wholly-owned foreign subsidiary, Grey Wolf Exploration Inc. ("New Grey Wolf"). In January 2003, the Company sold all of the common stock of its wholly-owned foreign subsidiaries, Canadian Abraxas Petroleum Limited ("Canadian Abraxas") and Grey Wolf Exploration Inc. ("Old Grey Wolf"). Certain oil and gas properties were retained and transferred into New Grey Wolf which was incorporated in January 2003. The operations of Canadian Abraxas and Old Grey Wolf are included in the consolidated financial statements through January 23, 2003.

New Grey Wolf's assets and liabilities are translated to U.S. dollars at period-end exchange rates. Income and expense items are translated at average rates of exchange prevailing during the period. Translation adjustments are accumulated as a separate component of shareholders' equity.

Stock-based Compensation:

The Company accounts for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Accordingly, compensation cost for stock options is measured as the excess, if any, of the quoted market price of the Company's stock at the date of the grant over the amount an employee must pay to acquire the stock.

Effective July 1, 2000, the Financial Accounting Standards Board ("FASB") issued FIN 44, "Accounting for Certain Transactions Involving Stock Compensation", an interpretation of APB No. 25. Under the interpretation, certain modifications to fixed stock option awards which were made subsequent to December 15, 1998, and were not exercised prior to July 1, 2000, require that the awards be accounted for as variable until they are exercised, forfeited, or expired. In January 2003, the Company amended the exercise price to \$0.66 on certain options with an existing exercise price greater than \$0.66. The Company recognized approximately \$757,000 and \$792,000 in expense during the quarter and six months ended June 30, 2003, respectively, as stock-based compensation expense in the accompanying consolidated financial statements. For the quarter and six months ended June 30, 2004 the Company recognized credits of approximately \$2.3 million and \$253,000, respectively, due to a decline in the

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price of its common stock during the period.

Pro forma information regarding net income (loss) and earnings (loss) per share is required by SFAS 123, "Accounting for Stock-Based Compensation" (SFAS 123), which also requires that the information be determined as if the Company has accounted for its employee stock options granted subsequent to December 31, 1995 under the fair value method prescribed by SFAS 123. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions for the quarter and six months ended June 30, 2004 and 2003, risk-free interest rates of 1.5%; dividend yields of -0-%; volatility factor of the expected market price of the Company's common stock of 0.35; and a weighted-average expected life of the option of ten years.

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The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

In October 2002, the FASB issued Statement No. 148 "Accounting for Stock-Based Compensation-Transition and Disclosure", (SFAS No. 148), providing alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also amends the disclosure requirement of SFAS No. 123, "Accounting for Stock-Based Compensation" to include prominent disclosures in annual and interim financial statements about the method of accounting for stock-based compensation and the effect of the method used on reported results. The Company adopted the disclosure provisions of SFAS No. 148 on December 31, 2002.

Had the Company determined stock-based compensation costs based on the estimated fair value at the grant date for its stock options, the Company's net income (loss) per share for the three and six months ended June 30, 2004 and June 30, 2003 would have been:

| | Three Months Ended June 30, | | Six Months Ended J | |
|---|---------------------------------------|------------|--------------------|----------|
| | 2004 | 2003 | 2004 | 2003 |
| | (In Thousands, except per share data) | | | |
| Net income (loss) as reported | \$ 372 | \$ (2,346) | \$ (5,185) | \$ 60,35 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | (2,316) | 757 | (253) | 79 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (35) | (271) | (71) | (14 |
| Pro forma net income (loss) | \$ (1,979) | \$ (1,860) | \$ (5,509) | \$ 61,00 |

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| | | | | |
|----------------------------|----|--------|----|--------|
| Earnings (loss) per share: | | | | |
| Basic - as reported | \$ | 0.01 | \$ | (0.07) |
| | | ===== | | ===== |
| Basic - pro forma | \$ | (0.05) | \$ | (0.05) |
| | | ===== | | ===== |
| Diluted - as reported | \$ | 0.01 | \$ | (0.07) |
| | | ===== | | ===== |
| Diluted - pro forma | \$ | (0.05) | \$ | (0.05) |
| | | ===== | | ===== |
| | | | | ===== |

Certain prior year balances have been reclassified for comparative purposes.

Note 2. 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 June 30, 2004, 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.

Note 3. Long-Term Debt

Long-term debt consisted of the following:

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| | June 30, | December 31, |
|---|----------------|--------------|
| | 2004 | 2003 |
| | (In thousands) | |
| 11.5% Secured Notes due 2007 ("new notes")..... | \$ 143,154 | \$ 137,258 |
| Senior Credit Agreement..... | 49,233 | 47,391 |
| | ----- | ----- |
| | 192,387 | 184,649 |
| Less current maturities | - | - |
| | ----- | ----- |
| | \$ 192,387 | \$ 184,649 |
| | ===== | ===== |

New Notes. In connection with the financial restructuring completed in January 2003, Abraxas issued \$109.7 million in principal amount of its 11 1/2% Secured Notes due 2007, Series A, or new notes, in exchange for our 11 1/2% Senior Notes due 2004 tendered in the exchange offer. The new notes were issued under an indenture with U.S. Bank, N. A. In accordance with SFAS 15, the basis of the new notes at issue date exceeded the face amount of the new notes by approximately \$19.0 million. Such amount will be amortized over the term of the new notes as an adjustment to the yield of the new notes.

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The new notes accrue interest from the date of issuance, at a fixed annual rate of 11 1/2%, payable in cash semi-annually on each May 1 and November 1, commencing May 1, 2003, provided that, if we fail, or are not permitted pursuant to our senior credit agreement or the intercreditor agreement between the trustee under the indenture for the new notes and the lenders under the senior credit agreement, to make such cash interest payments in full, we will pay such unpaid interest in kind by the issuance of additional new notes with a principal amount equal to the amount of accrued and unpaid cash interest on the new notes plus an additional 1% accrued interest for the applicable period. Upon an event of default, the new notes accrue interest at an annual rate of 16.5%.

The new notes are secured by a second lien or charge on all of our current and future assets, including, but not limited to, all of our crude oil and natural gas properties. All of Abraxas' current subsidiaries, Sandia Oil & Gas Corp., Sandia Operating Company, Wamsutter Holdings, Inc., New Grey Wolf, Western Associated Energy Corporation and Eastside Coal Company, Inc. are guarantors of the new notes, and all of Abraxas' future subsidiaries will guarantee the new notes. If Abraxas cannot make payments on the new notes when they are due, the guarantors must make them instead.

The new notes and related guarantees

- o are subordinated to the indebtedness under the senior credit agreement;
- o rank equally with all of Abraxas' current and future senior indebtedness; and
- o rank senior to all of Abraxas' current and future subordinated indebtedness, in each case, if any.

The new notes are subordinated to amounts outstanding under the senior credit agreement both in right of payment and with respect to lien priority and are subject to an intercreditor agreement.

Abraxas may redeem the new notes, at its option, in whole at any time or in part from time to time, at redemption prices expressed as percentages of the principal amount set forth below. If Abraxas redeems all or any new notes, it must also pay all interest accrued and unpaid to the applicable redemption date. The redemption prices for the new notes during the indicated time periods are as follows:

| Period | Percentage |
|---|------------|
| From June 24, 2004 to January 23, 2005..... | 98.5837% |
| Thereafter..... | 100.0000% |

Under the indenture, the Company is subject to customary covenants which, among other things, restricts our ability to:

- o borrow money or issue preferred stock;
- o pay dividends on stock or purchase stock;
- o make other asset transfers;

- o transact business with affiliates;
- o sell stock of subsidiaries;

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- o engage in any new line of business;
- o impair the security interest in any collateral for the notes;
- o use assets as security in other transactions; and
- o sell certain assets or merge with or into other companies.

In addition, we are subject to certain financial covenants including covenants limiting our selling, general and administrative expenses and capital expenditures, a covenant requiring Abraxas to maintain a specified ratio of consolidated EBITDA, as defined in the indenture, to cash interest and a covenant requiring Abraxas to permanently, to the extent permitted, pay down debt under the senior credit agreement and, to the extent permitted by the senior credit agreement, the new notes or, if not permitted, paying indebtedness under the senior credit agreement.

The indenture contains customary events of default, including nonpayment of principal or interest, violations of covenants, inaccuracy of representations or warranties in any material respect, cross default and cross acceleration to certain other indebtedness, bankruptcy, material judgments and liabilities, change of control and any material adverse change in our financial condition.

Senior Credit Agreement. In connection with the financial restructuring, Abraxas entered into a new senior credit agreement providing a term loan facility and a revolving credit facility. On February 23, 2004, the Company entered into an amendment to our existing senior credit agreement providing for two revolving credit facilities and a new non-revolving credit facility as described below. Subject to earlier termination on the occurrence of events of default or other events, the stated maturity date for these credit facilities is February 1, 2007. In the event of an early termination, we will be required to pay a prepayment premium, except in the limited circumstances described in the amended senior credit agreement.

First Revolving Credit Facility. Lenders under the amended senior credit agreement have provided Abraxas a revolving credit facility with a maximum borrowing base of up to \$20 million. The Company's current borrowing base under this revolving credit facility is the full \$20.0 million, subject to adjustments based on periodic calculations and mandatory prepayments under the senior credit agreement. The Company has borrowed \$6.6 million under this revolving credit facility, which was used to refinance principal and interest on advances under its preexisting revolving credit facility under the senior credit agreement, and to pay certain fees and expenses relating to the transaction. The outstanding balance under this facility was \$4.2 million as of June 30, 2004. Outstanding amounts under this revolving credit facility bear interest at the prime rate announced by Wells Fargo Bank, N.A. plus 1.125%.

Second Revolving Credit Facility. Lenders under the amended senior credit agreement have provided a second revolving credit facility, with a maximum borrowing of up to \$30.0 million. This revolving credit facility is not subject to a borrowing base. The Company has borrowed \$30.0 million under this revolving credit facility, which was used to refinance principal and interest on advances under our preexisting revolving credit facility, and to pay certain transaction fees and expenses. As of June 30, 2004 the outstanding balance of this facility was \$30.0 million. Outstanding amounts under this revolving credit facility bear interest at the prime rate announced by Wells Fargo Bank, N.A. plus 3.00%.

Non-Revolving Credit Facility. The Company has borrowed \$15.0 million pursuant to a non-revolving credit facility, which was used to repay the preexisting term loan under its senior credit agreement, to refinance principal and interest on advances under the preexisting revolving credit facility, and to

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pay certain transaction fees and expenses. This non-revolving credit facility is not subject to a borrowing base. As of June 30, 2004 the outstanding balance of this facility was \$15.0 million. Outstanding amounts under this credit facility bear interest at the prime rate announced by Wells Fargo Bank, N.A. plus 8.00%.

Covenants. Under the amended senior credit agreement, we are subject to customary covenants and reporting requirements. Certain financial covenants require us to maintain minimum ratios of consolidated EBITDA (as defined in the amended senior credit agreement) to adjusted fixed charges (which includes certain capital expenditures), minimum ratios of consolidated EBITDA to cash interest expense, a minimum level of unrestricted cash and revolving credit availability, minimum hydrocarbon production volumes and minimum proved developed hydrocarbon reserves. In addition, if on the day before the end of each fiscal quarter the aggregate amount of our cash and cash equivalents

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exceeds \$2.0 million, we are required to repay the loans under the amended senior credit agreement in an amount equal to such excess. The amended senior credit agreement also requires us to enter into hedging agreements on not less than 40% or more than 75% of our projected oil and gas production. We are also required to establish deposit accounts at financial institutions acceptable to the lenders and we are required to direct our customers to make all payments into these accounts. The amounts in these accounts will be transferred to the lenders upon the occurrence and during the continuance of an event of default under the amended senior credit agreement.

In addition to the foregoing and other customary covenants, the amended senior credit agreement contains a number of covenants that, among other things, restrict our ability to:

- o incur additional indebtedness;
- o create or permit to be created liens on any of our properties;
- o enter into change of control transactions;
- o dispose of our assets;
- o change our name or the nature of our business;
- o make guarantees with respect to the obligations of third parties;
- o enter into forward sales contracts;
- o make payments in connection with distributions, dividends or redemptions relating to our outstanding securities, or
- o make investments or incur liabilities.

Security. The obligations of Abraxas under the amended senior credit agreement continue to be secured by a first lien security interest in substantially all of Abraxas' assets, including all crude oil and natural gas properties.

Guarantees. The obligations of Abraxas under the amended senior credit agreement continue to be guaranteed by Abraxas' subsidiaries, Sandia Oil & Gas, Sandia Operating, Wamsutter Holdings., New Grey Wolf, Western Associated Energy and Eastside Coal Company. The guarantees under the amended senior credit agreement continue to be secured by a first lien security interest in

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substantially all of the guarantors' assets, including all crude oil and natural gas properties.

Events of Default. The amended senior credit agreement contains customary events of default, including nonpayment of principal or interest, violations of covenants, inaccuracy of representations or warranties in any material respect, cross default and cross acceleration to certain other indebtedness, bankruptcy, material judgments and liabilities, change of control and any material adverse change in our financial condition.

Note 4. Earnings Per Share

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

| | Three Months Ended June 30, | | Six Mon |
|--|-----------------------------|------------|---------|
| | 2004 | 2003 | 2004 |
| Numerator: | | | |
| Net income (loss) before cumulative effect of accounting change (in thousands) | \$ 372 | \$ (2,346) | \$ (5, |
| Cumulative effect of accounting change | - | - | - |
| | \$ 372 | \$ (2,346) | \$ (5, |
| Denominator: | | | |
| Denominator for basic earnings per share - Weighted-average shares | 36,191,155 | 35,634,998 | 36,112 |
| Effect of dilutive securities: | | | |
| Stock options and warrants | 1,769,614 | - | - |
| | 37,960,769 | 35,634,998 | 36,112 |
| S-11 | | | |
| Dilutive potential common shares Denominator for diluted earnings per share - adjusted weighted-average shares and assumed Conversions | 37,960,769 | 35,634,998 | 36,112 |
| Basic earnings (loss) per share: | | | |
| Net income (loss) before cumulative effect of accounting change | \$ 0.01 | \$ (0.07) | \$ (0 |
| Cumulative effect of accounting change | - | - | - |
| Net earnings (loss) per common share - basic | \$ 0.01 | \$ (0.07) | \$ (0 |
| Diluted earnings (loss) per share: | | | |
| Net income (loss) before cumulative effect of accounting change | \$ 0.01 | \$ (0.07) | \$ (0 |
| Cumulative affect of accounting change | - | - | - |
| Net earnings (loss) per common share - diluted | \$ 0.01 | \$ (0.07) | \$ (0 |

For the three months ended June 30, 2003 and six months ended June 30, 2004, none of the shares issuable in connection with stock options or warrants are included in diluted shares. Inclusion of these shares would be antidilutive due to losses incurred in the period. Had there not been losses in this period,

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dilutive shares would have been 580,427 shares and 1,866,245 shares for the three months ended June 30, 2003 and the six months ended June 30, 2004, respectively.

Note 5. 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 June 30, 2004, the derivatives that the Company had in place were not designated as hedges, accordingly, changes in the fair value of the derivatives are recorded in current period oil and gas revenue.

Under the terms of our new senior credit agreement, the Company is required to maintain hedging agreements with respect to not less than 40% nor more than 75% of its crude oil and natural gas production for a rolling six month period.

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

| Time Period | Notional Quantities | Price |
|----------------|---|----------------|
| July 2004 | 2,000 MMBtu of production per day | Floor of \$4.0 |
| | 4,500 MMBtu of production per day | Floor of \$4.2 |
| | 500 Bbl of crude oil production per day | Floor of \$22. |
| August 2004 | 7,100 MMBtu of production per day | Floor of \$4.2 |
| | 400 Bbl of crude oil production per day | Floor of \$24. |
| September 2004 | 7,100 MMBtu of production per day | Floor of \$4.2 |
| | 400 Bbl of crude oil production per day | Floor of \$24. |
| October 2004 | 7,100 MMBtu of production per day | Floor of \$4.2 |
| | 400 Bbl of crude oil production per day | Floor of \$24. |
| November 2004 | 7,100 MMBtu of production per day | Floor of \$4.2 |
| | 400 Bbl of crude oil production per day | Floor of \$24. |
| December 2004 | 7,100 MMBtu of production per day | Floor of \$4.5 |
| | 400 Bbl of crude oil production per day | Floor of \$25. |
| January 2005 | 7,100 MMBtu of production per day | Floor of \$4.5 |
| | 400 Bbl of crude oil production per day | Floor of \$25. |

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Note 6. Contingencies - Litigation

In 2001 the Company and a limited partnership, of which Wamsutter is the general partner (the "Partnership"), were named in a lawsuit filed in U.S. District Court in the District of Wyoming. The claim asserts breach of contract, fraud and negligent misrepresentation by the Company and the Partnership related to the responsibility for year 2000 ad valorem taxes on crude oil and natural gas properties sold by the Company and the Partnership. In February 2002, a summary judgment was granted to the plaintiff in this matter and a final judgment in the amount of \$1.3 million was entered. The Company and the Partnership have filed an appeal. The Company has established a reserve in the amount of \$845,000, which represents the Company's share of the judgment. The

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Company believes these charges are without merit

Additionally, 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 June 30, 2004, the Company was not engaged in any legal proceedings that are expected, individually or in the aggregate, to have a material adverse effect on the Company.

Note 7. Comprehensive Income

Comprehensive income includes net income, losses and certain items recorded directly to Stockholder's Equity and classified as Other Comprehensive Income.

The following table illustrates the calculation of comprehensive income (loss) for the three and six months ended June 30, 2003 and 2004:

| | Three Months Ended June 30, | | Six M |
|--|-----------------------------|------------|-------|
| | 2004 | 2003 | 20 |
| | (In Thousands) | | |
| Net (loss) income..... | \$ 372 | \$ (2,346) | \$ |
| Other Comprehensive loss: | | | |
| Hedging derivatives | | | |
| Change in fair market value of outstanding hedge positions..... | - | (151) | |
| Foreign currency translation adjustment..... | (860) | 2,386 | |
| Other comprehensive income | (860) | 2,235 | |
| Comprehensive (loss) income..... | \$ (488) | \$ (111) | \$ |

Note 8. Business Segments

Business segment information about the three months and six months ended June 30, 2004 and 2003 in different geographic areas is as follows:

| | Three Months Ended June 30, 2004 | | |
|--|----------------------------------|----------|-----|
| | U.S. | Canada | Tot |
| | (In thousands) | | |
| Revenues | \$ 8,504 | \$ 3,763 | \$ |
| Operating income..... | \$ 4,243 | \$ 860 | \$ |
| General Corporate..... | | | |
| Interest expense, financing cost and amortization of deferred financing fees..... | | | |
| Income before income taxes..... | | | \$ |

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| Three Months Ended June 30, 2003 | | | |
|--|----------|----------------|-----|
| | U.S. | Canada | Tot |
| | | (In thousands) | |
| Revenues | \$ 7,218 | \$ 1,212 | \$ |
| Operating loss..... | \$ 3,335 | \$ 288 | \$ |
| General Corporate..... | | | |
| Interest expense and amortization of deferred financing fees..... | | | |
| Loss before income taxes..... | | | \$ |

| Six Months Ended June 30, 2004 | | | |
|--|-----------|----------------|-----|
| | U.S. | Canada | Tot |
| | | (In thousands) | |
| Revenues | \$ 16,464 | \$ 6,738 | \$ |
| Operating income..... | \$ 7,955 | \$ 1,267 | \$ |
| General Corporate..... | | | |
| Interest expense, financing cost and amortization of deferred financing fees..... | | | |
| Other..... | | | |
| Loss before income taxes..... | | | \$ |

| Six Months Ended June 30, 2003 | | | |
|--|-----------|----------------|-----|
| | U.S. | Canada | Tot |
| | | (In thousands) | |
| Revenues | \$ 16,017 | \$ 5,524 | \$ |
| Operating loss..... | \$ 8,071 | \$ 2,531 | \$ |
| General Corporate..... | | | |
| Interest expense and amortization of deferred financing fees..... | | | |
| Income before income taxes..... | | | |

| At June 30, 2004 | | | |
|---------------------------|-----------|----------------|-----|
| | U.S. | Canada | Tot |
| | | (In Thousands) | |
| Identifiable assets | \$ 82,820 | \$ 36,896 | \$ |
| Corporate assets..... | | | |

Total assets §

Note 9. New Accounting Standards

In March 2004, the Emerging Issues Task Force ("EITF") reached a consensus that mineral rights, as defined in EITF Issue No. 04-2, "Whether Mineral Rights Are Tangible or Intangible Assets," are tangible assets and that they should be removed as examples of intangible assets in SFAS No. 141, "Business Combinations" and No. 142, "Goodwill and Other Intangible Assets". The FASB has recently ratified this consensus and directed the FASB staff to amend SFAS Nos. 141 and 142 through the issuance of FASB Staff Position FAS Nos. 141-1 and 142-1. Historically, the Company has included the costs of such mineral rights as tangible assets, which is consistent with the EITF's consensus. As such, EITF 04-02 has not affected the Company's consolidated financial statements.

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Note 10. Accounting Change

The Company adopted SFAS 143 effective January 1, 2003. For the six months ended June 30, 2003 the Company recorded a charge of approximately \$395,000 for the cumulative effect of the change in accounting principle and an additional liability of approximately \$712,000. During the period ended June 30, 2004 the Company recorded an additional liability of approximately \$382,000.

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Management's Discussion and Analysis of Financial Condition
and Results of Operation

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, 2003. The results of operations of Canadian Abraxas and Old Grey Wolf are included in this report through January 23, 2003, the date of the consummation of the sale.

General

We are an independent energy company engaged primarily in the acquisition, exploration, exploitation and production of crude oil and natural gas. Our principal means of growth has been through the acquisition and subsequent development and exploitation of producing properties. As a result of our historical acquisition activities, we believe that we have a substantial inventory of low risk exploitation and development opportunities, the successful completion of which is critical to the maintenance and growth of our current production levels.

We have incurred net losses in three of the last five years, and there can be no assurance that operating income and net earnings will be achieved in future periods. Our financial results depend upon many factors, particularly the following factors which most significantly affect our results of operations:

- o the sales prices of crude oil, natural gas liquids and natural

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gas;

- o the level of total sales volumes of crude oil, natural gas liquids and natural gas;
- o the ability to raise 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 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, the market price of natural gas was at its highest level in our operating history and the price of crude oil was also at a high level. 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 2003 and have remained strong during the first half of 2004.

The table below illustrates how natural gas prices fluctuated over the eight quarters prior to and including the quarter ended June 30, 2004. The table below also contains the last three day average of NYMEX traded contracts price 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 | | | | | | |
|----------|----|-------------------|------------------|-------------------|------------------|-------------------|------------------|-------------------|
| | | Sept. 30, 2002 | Dec. 31, 2002 | March 31, 2003 | June 30, 2003 | Sept. 30, 2003 | Dec. 31, 2003 | March 31, 2004 |
| Index | \$ | 3.28 | \$ 3.99 | \$ 6.61 | \$ 5.51 | \$ 5.10 | \$ 4.60 | \$ 5.69 |
| Realized | \$ | 2.08 | \$ 3.47 | \$ 5.13 | \$ 5.11 | \$ 4.50 | \$ 4.30 | \$ 4.30 |

The NYMEX natural gas price on August 9, 2004 was \$5.69 per Mcf.

The table below illustrates how crude oil prices fluctuated over the eight quarters prior to and including the quarter ended June 30, 2004. The table below also contains the last three day average of NYMEX traded contracts price and the prices we realized during each quarter presented, including the impact of our hedging activities.

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

| | | Quarter Ended | | | | | | |
|--|--|---------------|--|--|--|--|--|--|
|--|--|---------------|--|--|--|--|--|--|

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| | Sept. 30, 2002 | Dec. 31, 2002 | March 31, 2003 | June 30, 2003 | Sept. 30, 2003 | Dec. 31, 2003 | Mar 2 |
|----------|-------------------|------------------|-------------------|------------------|-------------------|------------------|----------|
| Index | \$ 27.50 | \$ 28.29 | \$ 33.71 | \$ 29.87 | \$ 30.85 | \$ 29.64 | \$ 3 |
| Realized | \$ 23.47 | \$ 24.83 | \$ 33.22 | \$ 28.53 | \$ 29.52 | \$ 29.73 | \$ 3 |

The NYMEX crude oil price on August 9, 2004 was \$44.84 per Bbl.

We seek to reduce our exposure to price volatility by hedging our production through swaps, floors, options and other commodity derivative instruments.

Under the terms of our senior credit agreement, we are required to maintain hedging positions with respect to not less than 40% 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 |
|----------------|--|------------------|
| July 2004 | 2,000 MMBtu of production per day | Floor of \$4.00 |
| | 4,500 MMBtu of production per day | Floor of \$4.25 |
| | 500 Bbls of crude oil production per day | Floor of \$22.00 |
| August 2004 | 7,100 MMBtu of production per day | Floor of \$4.25 |
| | 400 Bbls of crude oil production per day | Floor of \$24.00 |
| September 2004 | 7,100 MMBtu of production per day | Floor of \$4.25 |
| | 400 Bbls of crude oil production per day | Floor of \$24.00 |
| October 2004 | 7,100 MMBtu of production per day | Floor of \$4.25 |
| | 400 Bbls of crude oil production per day | Floor of \$24.00 |
| November 2004 | 7,100 MMBtu of production per day | Floor of \$4.25 |
| | 400 Bbls of crude oil production per day | Floor of \$24.00 |
| December 2004 | 7,100 MMBtu of production per day | Floor of \$4.50 |
| | 400 Bbls of crude oil production per day | Floor of \$25.00 |
| January 2005 | 7,100 MMBtu of production per day | Floor of \$4.50 |
| | 400 Bbls of crude oil production per day | Floor of \$25.00 |

Production Volumes. Because our proved reserves will decline as crude oil, natural gas and natural gas liquids are produced, unless we acquire additional properties containing proved reserves or conduct successful exploration and 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, exploitation and development projects. For more information on the volumes of crude oil, natural gas liquids and natural gas we produced during the three and six months ended June 30, 2003 and 2004, please refer to the information under the caption "Results of Operations" below.

We have budgeted \$10 million for drilling expenditures in 2004, of which \$7.1 million was spent during the first six months of 2004. Under the terms of our senior credit agreement and our new notes, we are subject to limitations on

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capital expenditures. As a result, we will be limited in our ability to replace existing production with new production and might suffer a decrease in the volume of crude oil and natural gas we produce. 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. For more information, see "Liquidity and Capital Resources" below.

Availability of Capital. As described more fully under "Liquidity and Capital Resources" below, our sources of capital are primarily cash on hand, cash from operating activities, funding under our senior credit agreement and the sale of properties. At June 30, 2004, we had approximately \$15.6 million of availability under our senior credit agreement. Our capital expenditures are limited to \$10 million per year under the terms of the indenture for the notes. We may also attempt to raise additional capital or refinance our existing indebtedness through the issuance of debt or equity securities although we cannot assure you that we will be successful in any such efforts.

Borrowings and Interest. As a result of the financial restructuring we completed in January 2003, we reduced our indebtedness from approximately \$300.4 million at December 31, 2002 to approximately \$204.0 million at June 30, 2004.

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In addition, we decreased our cash interest expense from \$34.2 million during 2002 to \$4.3 million during 2003. During the first six months of 2004, our cash interest expense was \$3.0 million. By decreasing the amount of our indebtedness and required cash interest payments, more of our capital resources can be utilized for drilling activities and paying other expenses.

Exploitation and Development Activity. During the second quarter of 2004, we continued exploitation activities on our properties. We invested \$7.1million in capital spending on these activities during the first six months of 2004.

Outlook for 2004. As a result of final 2003 financial results and current market conditions, Abraxas has updated its operating and financial guidance for year 2004 as follows:

| | |
|---|-------|
| Production: | |
| BCFE (approximately 80% gas)..... | 8-9 |
| Price Differentials (Pre Hedge): | |
| \$ Per Bbl..... | 0.86 |
| \$ Per Mcf..... | 0.64 |
| Lifting Costs, \$ Per Mcfe..... | 1.29 |
| G&A, \$ Per Mcfe..... | 0.60 |
| Capital Expenditures (\$ Millions)..... | 10.00 |

Actual results could materially differ and will depend on, among other things, our ability to successfully increase our production of crude oil, natural gas liquids and natural gas through our drilling activities. We undertake no duty to update these forward-looking statements.

Critical Accounting Policies

There have been no changes from the Critical Accounting Polices described in our Annual Report on Form 10-K for the year ended December 31, 2003.

Results of Operations

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

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| | Three Months Ended June 30, | | |
|--|--------------------------------|-----------------|-----------|
| | 2004 | 2003 | |
| Operating Revenue (in thousands): | | | |
| Crude Oil Sales* | \$ 2,407 | \$ 1,651 | \$ |
| Natural Gas Sales* | 9,213 | 6,494 | |
| Natural Gas Liquids Sales | 419 | 116 | |
| Processing Revenue | - | - | |
| Rig Operations | 129 | 158 | |
| Other | 99 | 11 | |
| | <u>\$ 12,267</u> | <u>\$ 8,430</u> | <u>\$</u> |
| Operating Income (Loss) in thousands)..... | | | |
| Crude Oil Production (MBbls) | 65 | 58 | |
| Natural Gas Production (MMcfs) | 1,760 | 1,272 | |
| Natural Gas Liquids Production (MBbls) | 14 | 5 | |
| Average Crude Oil Sales Price (\$/Bbl) | \$ 37.09 | \$ 28.53 | \$ |
| Average Natural Gas Sales Price (\$/Mcf) | \$ 5.23 | \$ 5.11 | \$ |
| Average Liquids Sales Price (\$/Bbl) | \$ 30.97 | \$ 22.10 | \$ |

(1) Data for the first 23 days of 2003 includes Canadian subsidiaries sold in January 2003.

*Revenue and average sales prices are net of hedging activities.

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Comparison of Three Months Ended June 30, 2004 to Three Months Ended June 30, 2003

Operating Revenue. During the three months ended June 30, 2004, operating revenue from crude oil, natural gas and natural gas liquid sales increased to \$12.0 million compared to \$8.3 million in the three months ended June 30, 2003. The increase in revenue was due to increased production volumes and by higher commodity prices realized during the period. Increased production volumes contributed \$2.8 million to revenue while higher commodity prices contributed \$0.9 million to crude oil and natural gas revenue.

Average sales prices net of hedging cost for the quarter ended June 30, 2004 were:

- o \$ 37.09 per Bbl of crude oil,
- o \$ 30.97 per Bbl of natural gas liquid, and
- o \$ 5.23 per Mcf of natural gas

Average sales prices net of hedging cost for the quarter ended June 30, 2003 were:

- o \$ 28.53 per Bbl of crude oil,
- o \$ 22.10 per Bbl of natural gas liquid, and

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- o \$ 5.11 per Mcf of natural gas

Crude oil production volumes increased from 57.9 MBbls during the quarter ended June 30, 2003 to 65.0 MBbls for the same period of 2004. The increase in production volumes was due to new production during the quarter, primarily related to our Canadian operations. Crude oil production volumes related to our Canadian operations increased from 4.2 MBbls during the quarter ended June 30, 2003 to 9.5 MBbls for the same period of 2004. Crude oil production from United States operations increased from 53.7 MBbls for the quarter ended June 30, 2003 to 55.4 MBbls for the same period of 2004. Natural gas production volumes increased to 1,760 MMcf for the three months ended June 30, 2004 from 1,272 MMcf for the same period of 2003. The increase in natural gas production volumes was attributable to new production during the quarter ended June 30, 2004, primarily related to our Canadian operations. Natural gas production related to our Canadian operations increased from 186.4 MMcf for the quarter ended June 30, 2003 to 627.7 MMcf for the same period of 2004.

Lease Operating Expenses. Lease operating expenses ("LOE") for the three months ended June 30, 2004 increased to \$3.3 million from \$2.1 million for the same period in 2003. The increase in LOE was primarily due to increased production taxes related to higher commodity prices and increased production, and startup cost related to previously stranded gas in Canada. Our LOE on a per Mcfe basis for the three months ended June 30, 2004 was \$1.48 per Mcfe compared to \$1.25 for the same period of 2003.

General and Administrative Expenses ("G&A"). G&A expenses increased to \$2.2 million for the quarter ended June 30, 2004 from \$1.2 million for the same period of 2003. The increase in G&A expense was primarily due to performance bonuses paid during the quarter ended June 30, 2004. G&A expense on a per Mcfe basis was \$0.99 for the second quarter of 2004 compared to \$0.75 for the same period of 2003. The per Mcfe increase was attributable to higher G&A expense offset by increased production volumes during the second quarter of 2004 as compared to the same period of 2003. G&A cost for the balance of 2004 are expected to return to historical levels.

Stock-based Compensation. Effective July 1, 2000, the Financial Accounting Standards Board ("FASB") issued FIN 44, "Accounting for Certain Transactions Involving Stock Compensation", an interpretation of Accounting Principles Board Opinion No. ("APB") 25. Under the interpretation, certain modifications to fixed stock option awards which were made subsequent to December 15, 1998, and not exercised prior to July 1, 2000, require that the awards be accounted for as variable expenses until they are exercised, forfeited, or expired. In January 2003, we amended the exercise price to \$0.66 per share on certain options with an existing exercise price greater than \$0.66 per share. We recognized expense of approximately \$757,000 during the quarter ended June 30, 2003 related to these repricings. During the quarter ended June 30, 2004, we recognized a credit to stock based compensation of \$2.3 million. The credit was due to a decrease in our common stock price as of June 30, 2004 from the price as of March 31, 2004.

Depreciation, Depletion and Amortization Expenses. Depreciation, depletion and amortization ("DD&A") expense increased to \$3.2 million for the three months ended June 30, 2004 from \$2.3 million for the same period of 2003. The increase in DD&A was primarily due to increased production volumes during the quarter ended June 30, 2004 as compared to the same period of 2003. Our DD&A on a per Mcfe basis for the quarter ended June 30, 2004 was \$1.44 per Mcfe as compared to \$1.39 in 2003.

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Interest Expense. Interest expense increased to \$4.3 million for the second quarter of 2004 compared to \$3.8 million for the same period of 2003. The

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increase in interest expense was due to an increase in our overall long-term debt from \$176.6 million as of June 30, 2003 to \$192.4 million as of June 30, 2004. The increase in long-term debt was due to the issuance of additional notes in payment of interest on our 11.5% Secured Notes.

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 Six Months Ended June 30, 2004 to Six Months Ended June 30, 2003

Operating Revenue. During the six months ended June 30, 2004, operating revenue from crude oil, natural gas and natural gas liquid sales increased to \$22.8 million as compared to \$21.0 million in the six months ended June 30, 2003. The increase in revenue was due to increased production volumes and higher realized prices during the period. Increased production contributed \$1.3 million to revenue, while higher commodity prices contributed \$455,000. The increase in production volumes was a result of drilling operations in the latter part of 2003 and the first six months of 2004. The increase in production volumes was partially offset by the loss of production related to the Canadian properties sold in January 2003.

Average sales prices net of hedging cost for the six months ended June 30, 2004 were:

- o \$35.65 per Bbl of crude oil,
- o \$30.25 per Bbl of natural gas liquid, and
- o \$ 5.04 per Mcf of natural gas

Average sales prices net of hedging cost for the six months ended June 30, 2003 were:

- o \$31.03 per Bbl of crude oil,
- o \$24.64 per Bbl of natural gas liquid, and
- o \$ 5.12 per Mcf of natural gas

Crude oil production volumes increased to 128.9 MBbls during the six months ended June 30, 2004 from 123.3 MBbls for the same period of 2003. Crude oil production volumes related to our continuing Canadian operations increased to 17.2 MBbls during the six months ended June 30, 2004 from 8.5 MBbls for the same period of 2003. Offsetting the increased production was the loss of production related to the properties sold in connection with the sale of Old Grey Wolf and Canadian Abraxas in January 2003. The properties sold contributed 2.4 MBbls during the first 23 days of 2003 prior to the sale. Natural gas production volumes increased to 3,447 MMcf for the six months ended June 30, 2004 from 3,237 MMcf for the same period of 2003. As with the increase in crude oil volumes, the increase in natural gas production volumes was the result of drilling activities during the latter part of 2003 and the first six months of 2004, primarily related to our Canadian operations. Natural gas production related to our continuing Canadian operations increased from 345.3 MMcf for the first six months of 2003 to 1,149 MMcf for the same period of 2004. Offsetting the increase was the loss of production related to the Canadian properties sold in January 2003. Prior to the sale, these properties contributed 559.0 MMcf to 2003.

Lease Operating Expenses. Lease operating expenses for the six months ended June 30, 2004 increased to \$6.7 million from \$4.8 million for the same period in 2003. The increase was due to increased production taxes as a result of higher production volumes as well as pipeline charges in Canada related to startup cost associated with previously stranded gas. LOE on a per Mcfe basis for the six months ended June 30, 2004 was \$1.52 compared to \$1.16 for the same period of 2003.

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General and Administrative Expenses. G&A expenses increased to \$3.6 million for the first six months of 2004 from \$2.6 million for the first six months of 2003. The increase was primarily due to performance bonuses paid during the second quarter of 2004. G&A expense on a per Mcfe basis was \$0.81 for the first six months of 2004 compared to \$0.64 for the same period of 2003.

Stock-based Compensation. Effective July 1, 2000, the Financial Accounting Standards Board ("FASB") issued FIN 44, "Accounting for Certain Transactions

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Involving Stock Compensation", an interpretation of Accounting Principles Board Opinion No. ("APB") 25. Under the interpretation, certain modifications to fixed stock option awards which were made subsequent to December 15, 1998, and not exercised prior to July 1, 2000, require that the awards be accounted for as variable expenses until they are exercised, forfeited, or expired. In January 2003, we amended the exercise price to \$0.66 per share on certain options with an existing exercise price greater than \$0.66 per share. We recognized a credit of approximately \$253,000 during the six months ended June 30, 2004 due to the decline in the price of our common stock since December 31, 2003. We recorded an expense of approximately \$792,000 during the first six months of 2003.

Depreciation, Depletion and Amortization Expenses. Depreciation, depletion and amortization expense increased to \$6.3 million for the six months ended June 30, 2004 from \$5.4 million for the same period of 2003. The increase was primarily due to increased production volumes during the six months ended June 30, 2004 as compared to the same period of 2003. Our DD&A on a per Mcfe basis for the six months ended June 30, 2004 was \$1.43 per Mcfe as compared to \$1.32 in 2003.

Interest Expense. Interest expense increased to \$9.4 million for the first six months of 2004 compared to \$9.0 million in 2003. The increase in interest expense was due to an increase in our overall long-term debt from \$176.6 million as of June 30, 2003 to \$192.4 million as of June 30, 2004. The increase in long-term debt was due to the issuance of additional notes in payment of interest on our 11.5% Secured Notes.

Income taxes. Income taxes decreased to zero for the six months ended June 30, 2004 from \$377,000 for the six months ended June 30, 2003. There is no current or deferred income tax benefit for the current net losses due to the valuation allowance which has been recorded against such benefits.

Liquidity and Capital Resources

General. The crude oil and natural gas 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 crude oil and natural gas properties; and
- o production and transportation facilities.

The amount of capital available to us will affect our ability to service our existing debt obligations and to continue to grow the business through the development of existing properties and the acquisition of new properties.

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Our sources of capital are primarily cash on hand, cash from operating activities, funding under the senior credit agreement and the sale of properties. Our overall liquidity depends heavily on the prevailing prices of crude oil and natural gas and our production volumes of crude oil and natural gas. Significant downturns in commodity prices, such as that experienced in the last nine months of 2001 and the first quarter of 2002, can reduce our cash from operating activities. Although we have hedged a portion of our natural gas and crude oil production and will continue this practice as required pursuant to the senior credit agreement, future crude oil and natural gas price declines would have a material adverse effect on our overall results, and therefore, our liquidity. Low crude oil and natural gas prices could also negatively affect our ability to raise capital on terms favorable to us.

If the volume of crude oil and natural gas we produce decreases, our cash flow from operations will decrease. Our production volumes will decline as reserves are produced. In addition, due to sales of properties in January 2003, we now have reduced reserves and production levels. In the future 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 exploration, exploitation and development activities, acquire additional producing properties or identify additional behind-pipe zones or secondary recovery reserves. While we have had some success in pursuing these activities, historically we have not been able to fully replace the production volumes lost from natural field declines and property sales.

Working Capital. At June 30, 2004 we had current assets of \$9.0 million and current liabilities of \$9.8 million resulting in a working capital deficit of approximately \$800,000. This compares to a working capital deficit of \$2.4 million at December 31, 2003 and a working capital deficit of \$3.6 million at June 30, 2003. Current liabilities at June 30, 2004 consisted of trade payables of \$2.8 million, revenues due third parties of \$2.9 million, accrued interest of \$2.4, of which \$2.0 is non-cash and other accrued liabilities of \$1.7 million. Under our senior credit agreement we will have cash interest expense of approximately \$4.5 million for 2004. We do not expect to make cash interest

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payments with respect to the outstanding new notes, and the issuance of additional new notes in lieu of cash interest payments thereon will not affect our working capital balance.

Capital expenditures. Capital expenditures, excluding property divestitures during the first six months of 2004, were \$7.1 million compared to \$10.0 million during the same period of 2003. The table below sets forth the components of these capital expenditures on a historical basis for the six months ended June 30, 2004 and 2003.

| | Six Months Ended June 30, | |
|--------------------------------------|------------------------------|------|
| | 2004 | 2003 |
| | (dollars in thousands) | |
| Expenditure category (in thousands): | | |
| Development..... | \$ 6,232 | \$ |

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| | | | |
|---------------------------|----------|----|--|
| Facilities and other..... | 856 | | |
| | | | |
| Total..... | \$ 7,085 | \$ | |

During the six months ended June 30, 2004 and 2003, capital expenditures were primarily for the development of existing properties. For 2004, our capital expenditures are subject to limitations imposed under the new senior credit facility and new notes, including a maximum annual capital expenditure budget of \$10 million for 2004, which is subject to reduction in the event of a reduction in our net assets. Our capital expenditures could include expenditures for acquisition of producing properties if such opportunities arise, but we currently have no agreements, arrangements or undertakings regarding any material acquisitions. We have no material long-term capital commitments and are consequently able to adjust the level of our expenditures as circumstances dictate. Additionally, the level of capital expenditures will vary during future periods depending on market conditions and other related economic factors. Should the prices of crude oil and natural gas decline from current levels, our cash flows will decrease which may result in a reduction of the capital expenditures budget. If we decrease our capital expenditures budget, we may not be able to offset crude oil and natural gas production volumes decreases caused by natural field declines and sales of producing properties.

Sources of Capital. The net funds provided by and/or used in each of the operating, investing and financing activities are summarized in the following table and discussed in further detail below:

| | Six Months Ended June 30, | | |
|---|------------------------------|---------|----|
| | 2004 | | |
| | (dollars in thousand) | | |
| Net cash provided by operating activities | \$ | 7,308 | \$ |
| Net cash (used) in provided by investing activities | | (7,085) | |
| Net cash provided by (used) financing activities | | 738 | |
| | | | |
| Total | \$ | 961 | \$ |
| | | | |

Operating activities during the six months ended June 30, 2004 provided us \$7.3 million cash compared to providing \$4.0 million in the same period in 2003. Net income plus non-cash expense items during 2004 and net changes in operating assets and liabilities accounted for most of these funds. Financing activities provided approximately \$738,000 for the first six months of 2004 compared to using \$83.6 million for the same period of 2003. Investing activities used \$7.1 million for the six months ended June 30, 2004 compared to providing \$76.6 million for the same period of 2003. Expenditures during the six months ended June 30, 2004 were primarily for the development of existing properties. The sale of our Canadian subsidiaries contributed \$86.6 million in 2003 reduced by \$10.0 million in exploration and development expenditures.

Future Capital Resources. We will have four principal sources of liquidity going forward: (i) cash on hand, (ii) cash from operating activities, (iii) funding under the new senior credit agreement, and (iv) sales of producing properties. However, covenants under the indenture for the outstanding new notes and the new senior credit agreement restrict our use of cash on hand, cash from operating

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activities and any proceeds from asset sales. We may attempt to raise additional capital or refinance our existing indebtedness through the issuance of additional debt or equity securities, though the terms of the new note indenture and the new senior credit agreement substantially restrict our ability to:

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- o incur additional indebtedness;
- o incur liens;
- o pay dividends or make certain other restricted payments;
- o consummate certain asset sales;
- o enter into certain transactions with affiliates;
- o merge or consolidate with any other person; or
- o sell, assign, transfer, lease, convey or otherwise dispose of all or substantially all of our assets.

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 June 30, 2004:

Contractual Obligations
(dollars in thousands)

Payments due in:

| | Total | Less than one year | 1-3 years | 3-5 years | More than years |
|----------------------|------------|-----------------------|------------|-----------|--------------------|
| Long-Term Debt (1) | \$ 245,367 | \$ - | \$ 245,367 | \$ - | \$ |
| Operating Leases (2) | 1,186 | 414 | 692 | 80 | |
| Total | \$ 246,553 | \$ 414 | \$ 246,059 | \$ 80 | \$ |

(1) These amounts represent the balances outstanding under the term loan facility, the revolving credit facility and the new notes. These repayments assume that interest will be capitalized under the term loan facility and that periodic interest on the revolving credit facility will be paid on a monthly basis and that we will not draw down additional funds there under.

(2) Office lease obligations. Leases for office space for Abraxas and New Grey Wolf expire in April 2006 and December 2008, respectively.

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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 crude oil and natural gas. 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. The following table sets forth our long-term indebtedness as of June 30, 2004 and December 31, 2003.

| | June 30, 2004 | December 31, 2003 |
|---|------------------|----------------------|
| (dollars in thousands) | | |
| 11.5% Secured Notes due 2007 ("new notes")..... | \$ 143,154 | \$ 137,258 |
| Senior Secured Credit Agreement..... | 49,233 | 47,391 |
| | 192,387 | 184,649 |
| Less current maturities | - | - |
| | \$ 192,387 | \$ 184,649 |

For financial reporting purposes, the new notes are reflected at the carrying value of our 11 1/2% Senior Notes due 2004 of \$191.0 million, net of the cash

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offered in the exchange of \$47.5 million and net of the fair market value related to equity of \$3.8 million offered in January 2003. The face amount of the new notes was \$128.0 million at June 30, 2004 including \$18.3 million in new notes issued for interest.

New Notes. The new notes accrue interest from the date of issuance, at a fixed annual rate of 11 1/2%, payable in cash semi-annually on each May 1 and November 1, commencing May 1, 2003. We will pay such unpaid interest in kind by the issuance of additional new notes with a principal amount equal to the amount of accrued and unpaid cash interest on the new notes plus an additional 1% accrued interest for the applicable period. Upon an event of default, the New Notes accrue interest at an annual rate of 16.5%.

The new notes are secured by a second lien or charge on all of our current and future assets, including, but not limited to, all of our crude oil and natural gas properties. All of Abraxas' current subsidiaries, Sandia Oil & Gas, Sandia Operating, Wamsutter, New Grey Wolf, Western Associated Energy and Eastside Coal, are guarantors of the new notes, and all of Abraxas' future subsidiaries will guarantee the new notes. If Abraxas cannot make payments on the new notes when they are due, the guarantors must make them instead.

The new notes and related guarantees

- o are subordinated to the indebtedness under the senior secured credit agreement;

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- o rank equally with all of Abraxas' current and future senior indebtedness; and
- o rank senior to all of Abraxas' current and future subordinated indebtedness, in each case, if any.

The new notes are subordinated to amounts outstanding under the senior secured credit agreement both in right of payment and with respect to lien priority and are subject to an intercreditor agreement.

Abraxas may redeem the new notes, at its option, in whole at any time or in part from time to time, at redemption prices expressed as percentages of the principal amount set forth below. If Abraxas redeems all or any new notes, it must also pay all interest accrued and unpaid to the applicable redemption date. The redemption prices for the new notes during the indicated time periods are as follows:

| Period | Percentage |
|---|------------|
| From June 24, 2004 to January 23, 2005..... | 98.5837% |
| Thereafter..... | 100.0000% |

Under the indenture, we are subject to customary covenants which, among other things, restrict our ability to:

- o borrow money or issue preferred stock;
- o pay dividends on stock or purchase stock;
- o make other asset transfers;
- o transact business with affiliates;
- o sell stock of subsidiaries;
- o engage in any new line of business;
- o impair the security interest in any collateral for the notes;
- o use assets as security in other transactions; and
- o sell certain assets or merge with or into other companies.

In addition, we are subject to certain financial covenants including covenants limiting our selling, general and administrative expenses and capital expenditures, a covenant requiring Abraxas to maintain a specified ratio of consolidated EBITDA, as defined in the agreements, to cash interest and a covenant requiring Abraxas to permanently, to the extent permitted, pay down debt under the new senior secured credit agreement and, to the extent permitted by the new senior secured credit agreement, the new notes or, if not permitted, paying indebtedness under the new senior secured credit agreement.

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The indenture contains customary events of default, including nonpayment of principal or interest, violations of covenants, inaccuracy of representations or warranties in any material respect, cross default and cross acceleration to certain other indebtedness, bankruptcy, material judgments and liabilities, change of control and any material adverse change in our financial condition.

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Senior Credit Agreement. In connection with the financial restructuring, Abraxas entered into a new senior credit agreement providing a term loan facility and a revolving credit facility as described below. Subsequently, on February 23, 2004, Abraxas entered into an amendment to its existing senior credit agreement providing for two revolving credit facilities and a new non-revolving credit facility as described below. Subject to earlier termination on the occurrence of events of default or other events, the stated maturity date for these credit facilities is February 1, 2007. In the event of an early termination, we will be required to pay a prepayment premium, except in the limited circumstances described in the amended senior credit agreement.

First Revolving Credit Facility. Lenders under the amended senior credit agreement have provided a revolving credit facility to Abraxas with a maximum borrowing base of up to \$20.0 million. Our current borrowing base under this revolving credit facility is the full \$20.0 million, subject to adjustments based on periodic calculations. We have borrowed \$6.6 million under this revolving credit facility, which was used to refinance principal and interest on advances under our preexisting revolving credit facility under the senior credit agreement, and to pay certain fees and expenses relating to the transaction. Outstanding amounts under this revolving credit facility bear interest at the prime rate announced by Wells Fargo Bank, N.A. plus 1.125%. The balance of this revolving credit facility was \$4.2 million as of June 30, 2004.

Second Revolving Credit Facility. Lenders under the amended senior credit agreement have provided a second revolving credit facility to Abraxas, with a maximum borrowing of up to \$30.0 million. This revolving credit facility is not subject to a borrowing base. We have borrowed \$30.0 million under this revolving credit facility, which was used to refinance principal and interest on advances under our preexisting revolving credit facility, and to pay certain transaction fees and expenses. As of June 30, 2004 the outstanding balance of this facility was \$30.0 million. Outstanding amounts under this revolving credit facility bear interest at the prime rate announced by Wells Fargo Bank, N.A. plus 3.00%.

Non-Revolving Credit Facility. Abraxas has borrowed \$15.0 million pursuant to a non-revolving credit facility, which was used to repay the preexisting term loan under our senior credit agreement, to refinance principal and interest on advances under the preexisting revolving credit facility, and to pay certain transaction fees and expenses. This non-revolving credit facility is not subject to a borrowing base. As of June 30, 2004 the outstanding balance of this facility was \$15.0 million. Outstanding amounts under this credit facility bear interest at the prime rate announced by Wells Fargo Bank, N.A. plus 8.00%.

Covenants. Under the amended senior credit agreement, Abraxas is subject to customary covenants and reporting requirements. Certain financial covenants require Abraxas to maintain minimum ratios of consolidated EBITDA (as defined in the amended senior credit agreement) to adjusted fixed charges (which includes certain capital expenditures), minimum ratios of consolidated EBITDA to cash interest expense, a minimum level of unrestricted cash and revolving credit availability, minimum hydrocarbon production volumes and minimum proved developed hydrocarbon reserves. In addition, if on the day before the end of each fiscal quarter the aggregate amount of our cash and cash equivalents exceeds \$2.0 million, we are required to repay the loans under the amended senior credit agreement in an amount equal to such excess. The amended senior credit agreement also requires us to enter into hedging agreements on not less than 40% or more than 75% of our projected oil and gas production. We are also required to establish deposit accounts at financial institutions acceptable to the lenders and we are required to direct our customers to make all payments into these accounts. The amounts in these accounts will be transferred to the lenders upon the occurrence and during the continuance of an event of default under the amended senior credit agreement.

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In addition to the foregoing and other customary covenants, the amended senior credit agreement contains a number of covenants that, among other things, restrict our ability to:

- o incur additional indebtedness;
- o create or permit to be created liens on any of our properties;
- o enter into change of control transactions;
- o dispose of our assets;

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- o change our name or the nature of our business;
- o make guarantees with respect to the obligations of third parties;
- o enter into forward sales contracts;
- o make payments in connection with distributions, dividends or redemptions relating to our outstanding securities, or
- o make investments or incur liabilities.

Security. The obligations of Abraxas under the amended senior credit agreement continue to be secured by a first lien security interest in substantially all of Abraxas' assets, including all crude oil and natural gas properties.

Guarantees. The obligations of Abraxas under the amended senior credit agreement continue to be guaranteed by Abraxas' subsidiaries, Sandia Oil & Gas, Sandia Operating, Wamsutter, New Grey Wolf, Western Associated Energy and Eastside Coal. The guarantees under the amended senior credit agreement continue to be secured by a first lien security interest in substantially all of the guarantors' assets, including all crude oil and natural gas properties.

Events of Default. The amended senior credit agreement contains customary events of default, including nonpayment of principal or interest, violations of covenants, inaccuracy of representations or warranties in any material respect, cross default and cross acceleration to certain other indebtedness, bankruptcy, material judgments and liabilities, change of control and any material adverse change in our financial condition.

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 senior credit agreement, we are required to maintain hedge positions on not less than 40% or more than 75% of our projected oil and gas production for a six month rolling period. See "General - Commodity Prices and Hedging Activities" and "Item 3--Quantitative and Qualitative Disclosures about Market Risk--Hedging Sensitivity" for further information.

Net Operating Loss Carryforwards.

At December 31, 2003, the Company had, subject to the limitation discussed below, \$100.6 million of net operating loss carryforwards for U.S. tax purposes. These loss carryforwards will expire through 2022 if not utilized. In connection

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with January 2003 transactions described in Note 2 in Notes to Consolidated Financial Statements, certain of the loss carryforwards were utilized.

Uncertainties exist as to the future utilization of the operating loss carryforwards under the criteria set forth under FASB Statement No. 109. Therefore, the Company has established a valuation allowance of \$76.1 million as of December 31, 2003 and June 30, 2004.

Quantitative and Qualitative Disclosures about Market Risk.

Commodity Price Risk

As an independent crude oil and natural gas 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 crude oil, natural gas and natural gas liquids. 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 crude oil and natural gas 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 crude oil and natural gas 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 six months ended June 30, 2004, a 10% decline in crude oil,

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natural gas and natural gas liquids prices would have reduced our operating revenue, cash flow and net income by approximately \$2.3 million for the period.

Hedging Sensitivity

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 June 30, 2004 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 amended senior credit agreement, we are required to maintain hedging positions with respect to not less than 40% nor more than 75% of our crude oil and natural gas production for a rolling six month period.

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

Interest rate risk

As a result of the financial restructuring that occurred in January 2003, and the amendment to the senior credit agreement in February 2004, the debt under the senior credit agreement bears interest at the bank prime plus various points. As of June 30, 2004 we had \$49.2 million in outstanding indebtedness

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under the new agreement. For every percentage point that the prime rate rises, our interest expense would increase by approximately \$492,000 on an annual basis. Our new notes accrue interest at fixed rates. A change in interest rates impacts the net market value of the Company's fixed rate debt, but has no impact on interest incurred or cash flows.

Foreign Currency

Our Canadian operations are measured in the local currency of Canada. As a result, our financial results are affected by changes in foreign currency exchange rates or weak economic conditions in the foreign markets. Canadian operations reported a pre-tax income of \$1.0 million for the six months ended June 30, 2004. It is estimated that a 5% change in the value of the U.S. dollar to the Canadian dollar would have changed our net income by approximately \$50,000. We do not maintain any derivative instruments to mitigate the exposure to translation risk. However, this does not preclude the adoption of specific hedging strategies in the future.