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PYRAMID OIL CO  
Form 10KSB  
March 30, 2007

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U.S. SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-KSB

- Annual report under Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2006
- Transition report under Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-5525

PYRAMID OIL COMPANY  
(Name of small business issuer in its charter)

CALIFORNIA  
(State or other jurisdiction of  
incorporation or organization)

94-0787340  
(I.R.S. Employer  
Identification No.)

2008 - 21st. Street, P. O. Box 832  
Bakersfield, California  
(Address of principal executive offices)

93302  
(Zip Code)

Issuer's telephone number: (661) 325-1000

Securities registered under Section 12 (b) of the Exchange Act: NONE

Securities registered under Section 12 (g) of the Exchange Act:

Common Stock  
(Title of Class)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

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

The issuer's revenues for the fiscal year ended December 31, 2006 were \$3,957,588.

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The aggregate market value on March 28, 2007, of the voting shares held by non-affiliates was approximately \$5,368,000 based on the closing sales price

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of the registrant's Common Stock on such date.

At March 28, 2007, there were 3,741,721 shares of Common Stock outstanding.

## DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for its 2007 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission within 120 days after the close of the registrant's fiscal year are incorporated by reference into Part III.

TRANSITIONAL SMALL BUSINESS DISCLOSURE FORMAT (check one): YES [  ] NO [  ]

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## PYRAMID OIL COMPANY 2006 FORM 10-KSB ANNUAL REPORT

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CAUTIONARY STATEMENT FOR PURPOSES OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 AND OTHER FEDERAL SECURITIES LAWS

Pyramid Oil Company is including the following discussion to inform existing and potential security holders generally of some of the risks and uncertainties that can affect the Company and to take advantage of the "safe harbor" protection for forward-looking statements afforded under the federal securities laws. Statements made in this Annual Report on Form 10-KSB may be forward-looking statements. In addition, from time to time, the Company may otherwise make forward-looking statements to inform existing and potential security holders about the Company. These statements may include projections and estimates concerning the timing and success of specific projects and the Company's future (1) income, (2) oil and gas production, (3) oil and gas reserves and reserve replacement and (4) capital spending. Forward-looking statements are generally accompanied by words such as "estimate," "project," "predict," "believe," "expect," "anticipate," "plan," "goal" or other words that convey the uncertainty of future events or outcomes. In addition, except for the historical information contained in this report, the matters discussed in this report are forward-looking statements. These statements by their nature are subject to certain risks, uncertainties and assumptions and will be influenced by various factors. Should any of the assumptions underlying a forward-looking statement prove incorrect, actual results could vary materially.

PART I

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ITEM 1 - DESCRIPTION OF BUSINESS

GENERAL BUSINESS DESCRIPTION

Pyramid Oil Company is a California corporation that has been in the oil and gas business continuously, since it was incorporated on October 9, 1909. Pyramid Oil Company, hereinafter referred to as "Pyramid" or the "Company," is engaged in the business of exploration, development and production of crude oil and natural gas.

Pyramid acquires interests in land and producing properties through acquisition and lease on which it drills and/or operates crude oil or natural gas wells in efforts to discover and/or to produce oil and gas. Crude oil and natural gas produced from these properties are sold to various refineries and pipeline companies. The majority of all oil and gas properties that Pyramid owns and operates is for its own account. Pyramid also participates in specific joint ventures with other companies in the development of oil and gas properties. Pyramid's interests in these properties will vary depending on the availability of said interests and their locations. Although the Company owns some minor oil and gas interests in New York and Wyoming, all of the Company's operations and major revenue producing properties are in California.

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The Company's executive offices are located at 2008 21st Street, Bakersfield, California, 93301, telephone (661) 325-1000, facsimile (661) 325-0100.

### DESCRIPTION OF BUSINESS - OIL AND GAS OPERATIONS

#### EXPLORATION AND DEVELOPMENT

Pyramid operates in a highly competitive industry wherein many companies, from large multinational companies to small independent producers, are competing for a finite amount of oil and gas resources. The Company seeks out properties to explore for oil and gas by drilling and also seeks out producing oil and gas properties that can be purchased and operated. Management believes that under the right economic conditions, several of the producing properties that the Company owns could have further developmental potential. Certain oil properties currently owned and operated by the Company may be receptive to enhanced oil recovery procedures under certain economic conditions.

#### OIL AND GAS PRODUCTION OPERATIONS

Pyramid owns and operates 27 oil and gas leases (properties) located within Kern and Santa Barbara Counties in the State of California. Eight of these properties were shut-in during 2006. All of these properties are capable of producing oil or natural gas, although not all of these properties are considered profitable under certain economic conditions. During 2006, the Company operated 19 leases within California, 17 of these leases had total annual gross oil production exceeding 1,000 barrels per lease. Production activities primarily consist of the daily pumping of oil from a well(s) into tanks, maintaining the production facilities both at the well and tank settings, preparing and shipping the crude oil to buyers. Daily operations differ from one property to another, depending on the number of wells, the depth of the wells, the gravity of the oil produced and the location of the property. All of Pyramid's oil production is classified as primary recovery production at this time; although certain properties may be conducive to secondary recovery operations in the future, depending on the prevailing price of oil.

Primary recovery of oil and gas is by means of natural flow(s) or artificial lift of oil and gas from a single well bore. Natural gas and petroleum fluids enter the well bore by means of reservoir pressure or gravity flow; fluids and gases are moved to the surface by natural pressure or by means of artificial lift (pumping). In secondary recovery operations, liquids or gases are injected into the reservoirs for the purpose of augmenting reservoir energy or increasing reservoir temperatures. Secondary recovery operations, usually, but not always, are done after the primary-recovery phase has passed.

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The Company employs field personnel (i.e., pumpers, rig crews, roustabouts and equipment operators) that perform basic daily activities associated with

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producing oil and gas. Daily operations include inspections of surface facilities and equipment, gauging, reporting and shipping oil, and routine maintenance and repair activities on wells, production facilities and equipment. The Company owns and maintains various pieces of equipment necessary for employees to perform various repair and maintenance tasks on Company properties. Such equipment consists of service rigs, mobile pumps, vacuum trucks, hot oil truck, backhoe, trucks and trailers.

Occasionally, the Company drills new wells or re-drills existing wells on properties owned by the Company in an attempt to increase oil and gas production. In the last five years, the Company has utilized the services of outside drilling contractors for drilling new wells and re-drilling existing wells. Maintenance and repairs of existing wells to maintain or increase oil and gas production are carried out by Company personnel on a continuing basis. Most maintenance and repair work is performed with Company rigs.

Economic factors associated with the price of oil and gas and the productive output of wells determine the number of active wells the Company operates. Under certain economic conditions, the Company has the potential to operate approximately 121 wells, and of these, approximately 61 were in operation during 2006. In December of 2005, the Company hired a petroleum engineer on a part-time basis to review all of the Company's oil and gas properties. One of the major objectives of this review is to identify the Company's current inactive wells that have the best potential to be returned to production under the current price levels. The Company also owns other oil and gas interests outside of California that it does not operate. These interests are located in Wyoming and New York.

### MARKETING OF CRUDE OIL AND NATURAL GAS

The Company sells its crude oil to ConocoPhillips and Kern Oil & Refining, accounting for approximately 57.5% and 39%, respectively, of Pyramid's crude oil and gas sales in 2006. While revenue from these customers is significant, and the loss of any one could have an adverse effect on the Company, it is management's opinion that the oil and gas it produces could be sold to other crude oil purchasers, refineries or pipeline companies. ConocoPhillips and Kern Oil have been customers of the Company for over ten years. Natural gas is sold to companies in the area of operations. The Company sells its oil pursuant to short-term contracts. Accordingly, the amount of oil the Company sells is dependent upon market demand. Market demand for Pyramid's production is subject to various influences and can never be assured, especially in an era of changing prices. The base values for crude oil the Company sells is set by major oil companies in response to area and market strengths and international influences. Types and qualities of crude oil vary substantially in base values posted by crude oil buyers in various areas of the country. Pyramid's crude oil sales are not seasonal, but uniform throughout the year.

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### RISKS, COMPETITION AND INDUSTRY CONDITIONS

The profitability of the Company's operations depends primarily on the production of oil and gas in commercially profitable quantities. Oil and gas properties often fail to provide a return sufficient to repay the substantial sums of money required for their acquisition, exploration and development. The acquisition, exploration and development of oil and gas properties is a highly competitive business. Many entities with which the Company competes have significantly greater financial and staff resources. Such competitive

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disadvantages could materially and adversely affect the Company's ability to acquire new properties or develop existing properties.

### REGULATIONS

The Company's business is affected by numerous governmental laws and regulations, including energy, environmental, conservation, tax and other laws and regulations relating to the petroleum industry. Changes in any of these laws and regulations could have a material and adverse effect on the Company's business and financial stability. In view of the many uncertainties with respect to current laws and regulations, including their applicability to the Company, the Company cannot predict the overall effect of such laws and regulations on future operations.

### TAXATION

The operations of the Company, as is the case in the petroleum industry generally, are significantly affected by federal tax laws. Federal, as well as state, tax laws have many provisions applicable to corporations which could affect the future tax liability of the Company.

### ENVIRONMENTAL

The Company's activities are subject to existing federal and state laws and regulations governing environmental quality and pollution control. These laws may require the acquisition of permits relating to certain ongoing operations, for drilling, emissions, waste water disposal and other air and water quality controls. In view of the uncertainty and unpredictability of environmental statutes and regulations, the Company cannot ensure that such laws and regulations will not materially and adversely affect the business of the Company. The Company does not currently anticipate any material effect on its capital expenditures or earnings as the result of governmental regulations, enacted or proposed, concerning environmental protection or the discharge of material into the environment. The Company is actively pursuing an ongoing policy of upgrading and restoring older properties to comply with current and proposed environmental regulations.

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### COMMITMENTS AND CONTINGENCIES

The Company is liable for future dismantlement and abandonment costs associated with its oil and gas properties. These costs include down-hole plugging and abandonment of wells, future site restoration, post closure and other environmental exit costs. The costs of future dismantlement and abandonment have been accrued and recorded in the financial statements. See Note 9 of Notes to Financial Statements included in Item 7 of this Form 10-KSB.

### OTHER

The Company employed thirteen full-time people as of December 31, 2006, three of whom were office or administrative personnel, and the rest of whom were field personnel. The Company contracts for additional labor services when

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needed. The Company is not a party to any union or labor contracts.

The Company had no material research and development costs for the three years ended December 31, 2006.

All of the Company's revenues during 2006 were derived from domestic sources.

The Company does not have any patents or trademarks, and it does not believe that its business or operations are dependent upon owning any patents or trademarks.

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### ITEM 2 - DESCRIPTION OF PROPERTY

#### (a) DESCRIPTION OF PROPERTIES

The principal assets of the Company consist of proven and unproven oil and gas properties, oil and gas production related equipment and developed and undeveloped real estate holdings. The Company's oil and gas properties are located exclusively in the continental United States, in California, Wyoming and New York.

Developed oil and gas properties are those on which sufficient wells have been drilled to economically recover the estimated reserves calculated for the property. Undeveloped properties do not presently have sufficient wells to recover the estimated reserves. The Company had no significant proved undeveloped properties at December 31, 2006, 2005 and 2004.

#### (b) OIL AND GAS PROPERTIES

The Company's estimated future net recoverable oil and gas reserves from proved reserves, both developed and undeveloped properties, were assembled by SI International, Inc., independent petroleum engineers, and are as follows:

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|                 | Crude Oil<br>(BBLs)<br>----- | Natural Gas<br>(MCF)<br>----- |
|-----------------|------------------------------|-------------------------------|
| January 1, 2007 | 741,000                      | 65,000                        |
| 2006            | 715,000                      | 94,000                        |
| 2005            | 522,000                      | 83,000                        |
| 2004            | 555,000                      | 83,000                        |
| 2003            | 554,000                      | 105,000                       |

The Company's estimated future net recoverable oil and gas reserves, noted in the table above, have not been filed with any other Federal authority or agency since January 1, 2006.

Using year-end oil and gas prices and lease operating expenses, the estimated value of future net revenues to be derived from Pyramid's proved developed oil and gas reserves, discounted at 10%, were \$12,358,000 at December 31, 2006, \$12,694,000 at December 31, 2005, \$4,643,000 at December 31, 2004, \$4,617,000 at December 31, 2003, and \$4,325,000 at December 31, 2002.

Pyramid participates in the drilling of developmental wells, no single one of which would cause a significant change in the net reserve figure.

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Pyramid's net oil and gas production after royalty and other working interests for the past five years ending December 31, were as follows.

|                   | 2006<br>---- | 2005<br>---- | 2004<br>---- | 2003<br>---- | 2002<br>---- |
|-------------------|--------------|--------------|--------------|--------------|--------------|
| Crude oil (Bbls)  | 66,000       | 71,000       | 72,000       | 74,000       | 66,000       |
| Natural gas (MCF) | 7,000        | 7,000        | 8,300        | 7,500        | 11,000       |

Pyramid's average sales prices per barrel or per MCF of crude oil and natural gas, respectively, and production costs per equivalent barrel (gas production is converted to equivalent barrels at the rate of 6 MCF per barrel, representing the estimated relative energy content of gas to oil) for the past five years ending December 31, were as follows:

|                  | 2006<br>----     | 2005<br>----     | 2004<br>----     | 2003<br>----     | 2002<br>----     |
|------------------|------------------|------------------|------------------|------------------|------------------|
| Sales price:     |                  |                  |                  |                  |                  |
| Crude oil        | \$58.88<br>===== | \$47.96<br>===== | \$36.24<br>===== | \$27.60<br>===== | \$22.86<br>===== |
| Natural gas      | \$ 7.28<br>===== | \$ 6.77<br>===== | \$ 5.89<br>===== | \$ 5.77<br>===== | \$ 3.08<br>===== |
| Production costs | \$22.80          | \$19.30          | \$18.20          | \$15.80          | \$15.30          |

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The average selling price of Pyramid's crude oil at December 31, 2006, was approximately \$55.57 per barrel and the average selling price of Pyramid's gas at December 31, 2006, was approximately \$ 8.45 per MCF.

As of December 31, 2006, Pyramid had the following gross and net position in wells and proved acres:

| WELLS     |         | PROVED ACRES |         |
|-----------|---------|--------------|---------|
| Gross (1) | Net (1) | Gross (2)    | Net (2) |
| 145       | 129     | 21,387       | 5,844   |
| ===       | ===     | =====        | =====   |

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- (1) "Gross wells" represents the total number of wells in which the Company has a working interest. "Net wells" represents the number of gross wells multiplied by the percentage of the working interests therein held by the Company.
- (2) "Gross acreage" represents all acres in which the Company has a working interest. "Net acres" represents the aggregate of the working interests of the Company in the gross acres.

The Company drilled four new wells in 2006, two on the Santa Fe lease, one on the Anderson lease and one joint-venture well. The Company participated with one other oil company as non-operator in the drilling of the joint venture well. The Company drilled two new wells in 2004, one on the Santa Fe lease and one joint-venture well. The Company participated with two other oil companies as operator in the drilling of the joint venture well. The Company also drilled a well in 2003 on the Anderson lease in the Carneros Creek Field. No wells were drilled in 2002 and 2005.

"Unproven" oil and gas properties are those on which the presence of commercial quantities of reserves of crude oil or natural gas has not been established.

"Undeveloped" acreage exists on those oil and gas properties where economically recoverable reserves are estimated to exist in proved reservoirs from wells to be drilled in the future.

As of December 31, 2006, Pyramid held positions in unproven acreage in the following locations:

|                                      | ACRES  |       |
|--------------------------------------|--------|-------|
|                                      | Gross  | Net   |
| New York                             |        |       |
| Mount Morris and Livingston Counties | 34,800 | 9,788 |
|                                      | =====  | ===== |

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### (c) REAL PROPERTY OWNED

Pyramid owned the following real property as of December 31, 2006, all located in California.

|                     |           |
|---------------------|-----------|
| County of Kern      |           |
| Mullaney yard       | 20 acres  |
| Grazing land        | 160 acres |
| Miller property     | 112 acres |
| Ranton property     | 80 acres  |
| City of Bakersfield | 3 lots    |

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Located on the three lots of real property in the city of Bakersfield is the Company's executive offices. This property was acquired by the Company in 1986. The office building located on this property is a one story structure with approximately 4,200 square feet in good condition.

### ITEM 3 - LEGAL PROCEEDINGS

The Company is subject to potential litigation within the normal course of business. The resolution in any reporting period of such litigation could have a material impact on Pyramid's financial position or results of operations for that period. Pyramid is not party to any proceedings or actions which management believes might have a material effect upon its financial position or results of operations.

### ITEM 4 - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of 2006.

## PART II

### ITEM 5 - MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

#### (a) PRICE RANGE OF COMMON SHARES

The common stock of Pyramid is traded on the OTC Bulletin Board under the symbol "PYOL" until August 21, 2006. Effective August 21, 2006, the Company's common stock began trading on the American Stock Exchange under the symbol "PDO". The following are high and low sales prices for each quarter of 2006 and 2005, and reflect inter-dealer prices without retail markup, markdown or commission.

|                            | High      | Low      |
|----------------------------|-----------|----------|
|                            | -----     | -----    |
| Fiscal Quarter Ending 2006 |           |          |
| March 31,                  | \$ 3.6335 | \$2.8668 |
| June 30,                   | 10.5000   | 3.1335   |
| September 30,              | 7.4900    | 4.2300   |
| December 31,               | 4.7000    | 3.7000   |

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Fiscal Quarter Ending 2005

|               |        |        |
|---------------|--------|--------|
| March 31,     | 6.0000 | 2.9000 |
| June 30,      | 4.5000 | 2.1500 |
| September 30, | 5.7500 | 3.2500 |
| December 31,  | 5.1000 | 3.9000 |

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At December 31, 2006, the Company had 279 shareholders of record, and an unknown number of additional holders whose stock is held in "street name".

On March 28, 2006, the Company's Board of Directors approved a 3 for 2 stock split payable on May 1, 2006, to shareholders of record as of April 17, 2006.

The Company did not repurchase any securities during 2006.

### ITEM 6 - MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

#### IMPACT OF CHANGING PRICES

Average prices increased by approximately \$10.66 per equivalent crude oil and gas barrel sold during 2006 as compared with average prices for 2005. In 2006 there were 240 separate crude oil price changes, as compared with 228 price changes in 2005. The difference between the highest (\$65.75) and lowest (\$33.75) posted prices in 2006 was \$32.00 per barrel. By comparison, this same differential in 2005 was \$32.00 per barrel.

#### LIQUIDITY AND CAPITAL RESOURCES

The Company had cash and short-term investments of \$2,070,000 at December 31, 2006, for a net decrease of \$672,000, when compared to December 31, 2005. Short-term investments consist of certificates of deposit having original maturities of three months or more. Operating activities generated cash of \$1,206,000 during 2006. During 2006, cash was consumed by capital spending of \$1,907,000 and principal payments on the Company's long-term debt totaling \$59,000. This was offset by proceeds from the issuance of long-term debt of \$32,000. The components of the changes in cash for 2006 are described in the Statements of Cash Flows included in Item 7 of this Form 10-KSB. Adequate funds were available to carry out all necessary oil and gas operations and to maintain its equipment. A \$500,000 line of credit, unused at December 31, 2006, also provided additional liquidity during 2006.

The Company believes that its existing current assets and the amount of cash it anticipates it will generate from current operations will be sufficient to fund the anticipated liquidity and capital resource needs of the Company for the fiscal year ended December 31, 2007. In addition to its current assets, the Company also has a credit facility for \$500,000 available in the event that it needs other resources to fund its liquidity and capital resource needs. Although the Company may increase its capital expenditures during the current fiscal year to enhance its current oil production capacities, it does not anticipate that such expenditures would exceed the amount of liquidity currently available to the Company. The Company's beliefs that its existing assets and the cash expected to be generated from operations will be sufficient during the current fiscal year are based on the following:

As of December 31, 2006, the amount of cash, cash equivalents, and short term investments was equal to \$2,070,000 in the aggregate.

As of December 31, 2006, the Company had approximately \$2,797,000 in current assets, and only \$593,000 of current liabilities.

As of December 31, 2006, the Company had only \$11,000 of long-term indebtedness (net of current maturities).

The Company is not a party to any off-balance sheet arrangements and does not engage in trading activities involving non-exchange traded contracts. In addition, the Company has no financial guarantees, debt or lease agreements or other arrangements that could trigger a requirement for an early payment or that could change the value of the Company's assets. Management continues to examine various alternatives for increasing capital resources including, among other things, participation with industry and/or private partners in drilling and exploration prospects and specific rework of existing properties to enhance production and expansion of its sales of crude oil and natural gas in California. If necessary, Pyramid could sell certain nonessential assets to raise capital for the benefit of these programs.

The Company drilled four wells in the year ended December 31, 2006. The Company drilled two wells in the year ended December 31, 2004. The Company drilled one well in the year ended December 31, 2003. No wells were drilled in 2002 and 2005. Two of the wells drilled, one each in 2006 and 2004 were exploratory wells. The exploratory wells drilled in 2004 and 2006 were abandoned due to non-economic production of crude oil.

The Company's crude oil reserves for the year ended December 31, 2006 increased due primarily to the drilling of four wells in 2006. The Company's crude oil reserves for the year ended December 31, 2005 increased due primarily to the recognition of proved developed non-producing and proved undeveloped reserves as a result of the review of the Company's geological data by independent petroleum engineers. The Company's crude oil reserves for the years ended December 31, 2004, 2003 and 2002, were stable. The Company was able to replace current production for 2004 and 2005, by drilling the wells in 2004 and 2003.

Certain properties that the Company owns have become uneconomic and have been shut-in. When these properties are not operated, any reserves that could be assigned to these properties are not included in the year-end engineering report of total Company reserves. Another major factor that directly affects the Company's future reserve base is the price of crude oil at December 31 of any given year. The year-end price of oil and gas has a significant impact on

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the estimated future net recoverable oil and gas reserves from proved developed properties. At certain depressed price levels, some of the Company's oil and gas properties are not economical to operate and thus its year-end engineering reserve reports do not assign any oil and gas reserves to these properties. Conversely, if year-end prices should increase to a certain level, the reserves on these leases would be economic to produce and would increase the Company's reserves.

### FORWARD-LOOKING INFORMATION

Looking forward into 2007, crude oil prices have increased by approximately \$3.70 per barrel as of March 28, 2007, compared to prices at December 31, 2006. There have been 57 separate price changes since December 31, 2006.

In January 2007, the Company drilled and completed a new well on its Anderson property, located within the Carneros Creek Field. The well was bottomed and completed at 3,390 feet after penetrating four oil bearing formations. The lowest zone, the Point of Rocks formation, was stimulated by a sand-oil fracturing processes and after the recovery of all stimulating fluids, oil production has been approximately 37 barrels per day of clean 31 gravity oil. The well has three oil zones behind pipe.

The Company plans to drill one or more additional well in the Carneros Creek area later this year, when a drilling rig becomes available. In addition to new drilling, the Company plans to re-work and stimulate several existing wells, with expectations of increasing oil production.

In January 2007, the Company and E&B Natural Resources Management Corporation abandoned it's joint venture exploratory well, drilled in 2006. After extensive testing it was determined that the formation was proved to be too tight even after two stimulation procedures and oil production was un-economical.

The Company continues to seek and evaluate opportunities within the energy sector, to enhance the value of the Company.

The Company's growth in 2007 will be highly dependant on the amount of success the Company has in its operations and capital investments, including the outcome of wells that have not yet been drilled. The Company's capital investment program may be modified during the year due to explorations and development successes or failures, market conditions and other variables. The production and sales of oil and gas involves many complex processes that are subject to numerous uncertainties, including reservoir risk, mechanical failures, human error and market conditions.

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The Company has positioned itself, over the past several years, to withstand various types of economic uncertainties, with a program of consolidating operations on certain producing properties and concentrating on properties that provide the major revenue sources. The drilling of a new well and several limited work-overs of certain wells have allowed the Company to maintain its crude oil reserves for the last three years. The Company expects to maintain its reserve base in 2007, by drilling new wells and routine maintenance of its existing wells.

The Company may be subject to future costs necessary for compliance with the new implementation of air and water environmental quality requirements of the various state and federal governmental agencies. The requirements and costs are unknown at this time, but management believes that costs could be

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significant in some cases. As the scope of the requirements become more clearly defined, management may be better equipped to determine the true costs to the Company.

The Company continues to absorb the costs for various state and local fees and permits under new environmental programs, the sum of which were not material during 2006. The Company retains outside consultants to assist the Company in maintaining compliance with these regulations. The Company is actively pursuing an ongoing policy of upgrading and restoring older properties to comply with current and proposed environmental regulations. The costs of upgrading and restoring older properties to comply with environmental regulations have not been determined. Management believes that these costs will not have a material adverse effect upon its financial position or results of operations.

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### ANALYSIS OF SIGNIFICANT CHANGES IN RESULTS OF OPERATIONS

Results of Operations for the Fiscal Year Ended December 31, 2006  
Compared to the Fiscal Year Ended December 31, 2005

#### REVENUES

Oil and gas sales increased by 14% for the year ended December 31, 2006, when compared with the same period for 2005. Oil and gas sales increased by 21% due to higher average prices for 2006. The average price of the Company's oil and gas increased by approximately \$10.66 per equivalent barrel for 2006 when compared to 2005. This was offset by a decrease in crude oil production/sales of approximately 5,000 barrels.

#### OPERATING EXPENSES

Operating expenses increased by approximately 10% for the year ended December

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31, 2006, when compared with the same period of 2005. The cost to produce an equivalent barrel of crude oil increased by approximately \$3.50 per barrel for 2006 when compared to 2005, for a total cost of approximately \$22.80 per equivalent barrel. The increase in operating expenses is due to an increase of 6% in labor costs, an increase of 2% in equipment rental and an increase of 2% in insurance expense. This was offset by a decrease of 4% in outside services. The remaining increase in operating expenses of 4%, is due to a number of offsetting positive and negative changes in various cost categories of less than 1% each.

Labor costs increased due to an increase in hourly labor rates and a bonus payment that was awarded to all employees. The increase in labor costs was necessary to ensure that the Company remained competitive with the local labor market. In addition, the Company hired an additional field level employee in March of 2006. Equipment rental increased due to rental of equipment for the Anderson #6 well. The Company rented a temporary crude oil storage tank, blowout prevention equipment and gas flare for this well. This accounted for almost all of the increase in equipment rental. Insurance costs increased due to higher premiums for liability insurance and health insurance. The reduction in the cost of outside services is due to lower expenditures for well work-overs. Fewer work-overs were done in the year ended December 31, 2006 versus the same period for 2005.

### EXPLORATION COSTS

In 2005, the Company entered into a Joint Venture Agreement with E & B Natural Resources for the drilling of an exploratory well on the Company's Santa Fe energy lease, section 32. E & B Natural Resources was the operator during the drilling of this well. The new well was drilled in the first quarter of 2006. As of December 31, 2006, the Company's share of costs for leaseholds and the drilling and completion of this well was approximately \$348,000. In November

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of 2006, a decision was made by the Company and its joint venture partners to abandon this well due to the fact that the well could not produce economic quantities of oil and gas. Therefore, the Company reclassified its share of costs for this well as exploration costs in the fourth quarter of 2006.

### GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses increased by approximately 28% for the year ended December 31, 2006. The increase is due primarily to a 13% increase in salaries. The increase in salaries is due primarily to bonuses that were paid during the third quarter of 2006 and salary increases that were effective July 1, 2006. Outside consulting fees increased by 6% due to the hiring of a petroleum engineer on a part-time basis. Audit fees increased by 4% due to additional costs of complying with Sarbanes-Oxley legislation

### PROVISION FOR DEPLETION, DEPRECIATION AND AMORTIZATION

The provision for depletion, depreciation and amortization increased by 29% for 2006, when compared with the same period for 2005. The increase is due primarily to a 23% increase in depletion of the Companies oil and gas properties. The increase in depletion is due primarily to an increase in depletion on two of the Company's oil and gas properties, the Santa Fe Energy and Anderson leases. The increase on these two properties is due primarily to higher crude oil production due to the completion of two new wells in the second quarter of 2006 and a new well in the third quarter of 2006.

### OTHER COSTS AND EXPENSES

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Other costs and expenses increased by approximately \$67,000. The increase is due primarily to the costs associated with the listing of the Company's common stock on the American Stock Exchange (AMEX) that was effective August 21, 2006.

### INTEREST INCOME

Interest income increased by approximately \$30,000 due to higher interest rates for 2006, as compared with the same period of 2005.

### OTHER INCOME

The increase in other income is due primarily to the sale of excess oil tools in the amount of \$25,000.

### INCOME TAX PROVISION

The Company's income tax provision consists of the current income tax for Federal and California Franchise tax, and the minimum corporate tax for New York.

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