ABRAXAS PETROLEUM CORP
Form 10-K
March 14, 2007

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Fiscal Year Ended December 31, 2006

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

COMMISSION FILE NUMBER 001-16701

ABRAXAS PETROLEUM CORPORATION
(Exact name of Registrant as specified in its charter)

Nevada	74-2584033
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

500 N. Loop 1604 East, Suite 100
San Antonio, Texas 78232
(Address of principal executive offices)

Registrant's telephone number, including area code (210) 490-4788

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

Title of each class:	Name of each exchange on which registered:
Common Stock, par value $.01 per share	American Stock Exchange

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.
Yes [ ] No [X]

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not 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-K or any amendment to this Form 10-K. [X]

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

Large accelerated filer [ ] Accelerated filer [X] Non-accelerated filer [ ]

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

As of June 30, 2006, the aggregate market value of the common stock held by non-affiliates of the registrant was $167,042,727 based on the closing sale price as reported on the American Stock Exchange.

As of March 9, 2007, there were 42,762,466 shares of common stock outstanding.

Documents Incorporated by Reference:

Document	Parts Into Which Incorporated
Portions of the registrant's Proxy Statement relating to the 2007 Annual Meeting of Shareholders to be held on May 23, 2007.	Part III

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

- our high debt level;
- our success in development and exploration activities;
- our ability to make planned capital expenditures;
- declines in our production of natural gas and crude oil;
- prices for natural gas and crude oil;

- our ability to raise equity capital or incur additional indebtedness;
- economic and business conditions;
- political and economic conditions in oil producing countries, especially those in the Middle East;
- price and availability of alternative fuels;
- our restrictive debt covenants;
- our acquisition and divestiture activities;
- results of our hedging activities; and
- other factors discussed elsewhere in this document.

Part I

Item 1. Business

As part of a series of restructuring transactions approved in 2004, we adopted a plan to dispose of our operations and interest in Grey Wolf Exploration Inc., a wholly-owned Canadian subsidiary of Abraxas Petroleum Corporation. In February 2005, Grey Wolf closed on an initial public offering resulting in our substantial divestiture of our capital stock in Grey Wolf. As a result of the disposal of Grey Wolf, the results of operations of Grey Wolf are reflected in our Financial Statements and in this document as "Discontinued Operations" and our remaining operations are referred to in our Financial Statements and in this document as "Continuing Operations" or "Continued Operations." Unless otherwise noted, all disclosures are for continuing operations. See Note 3 to the financial statements in Item 8.

In this report, PV-10 means estimated future net revenue discounted at a rate of 10% per annum, before income taxes and with no price or cost escalation or de-escalation in accordance with guidelines promulgated by the Securities and Exchange Commission. A Mcf is one thousand cubic feet of natural gas. MMcf is used to designate one million cubic feet of natural gas and Bcf refers to one billion cubic feet of natural gas. Mcfe means thousands of cubic feet of natural gas equivalents, using a conversion ratio of one barrel of crude oil to six Mcf of natural gas. MMcfe means millions of cubic feet of natural gas equivalents and Bcfe means billions of cubic feet of natural gas equivalents. MMBtu means million British Thermal Units. The term Bbl means one barrel of crude oil or natural gas liquids and MBbls is used to designate one thousand barrels of crude oil or natural gas liquids.

General

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

Our core areas of operation are in south and west Texas and east central Wyoming. Our current producing properties are typically characterized by long-lived reserves, established production profiles and an emphasis on natural gas. At December 31, 2006, we owned interests in 101,815 gross acres (87,554 net acres) applicable to our continuing operations, and operated properties accounting for approximately 95% of our PV-10, affording us substantial control over the timing and incurrence of operating and capital expenditures. At December 31, 2006, estimated total proved reserves were 98.8 Bcfe with an aggregate PV-10 of $161 million. During 2006, we participated in the drilling of 5 gross (4.2 net) wells with 4 gross (3.2 net) wells being successful. Total capital expenditures for 2006 were approximately $26 million, of which 35% was spent on 2 wells in the SW Oates Field of West Texas which were still in progress at year-end. Overall, during 2006 we added approximately 3.6 Bcfe of proved reserves which was offset by 1.8 Bcfe of property sales and 7.7 Bcfe of production.

We believe that our high quality asset base, high degree of operational control and large inventory of drilling projects positions us for future growth. Our properties are concentrated in locations that facilitate substantial economies of scale in drilling and production operations and efficient reservoir management practices. In addition, we have 51 proved undeveloped projects and have identified over 500 drilling and recompletion opportunities on our existing acreage, the successful development of which we believe could significantly increase our daily production and proved reserves. We have approved a capital budget ranging from $27.0 to $44.0 million for 2007, (the final amount of which will depend upon our cash flow from operations which, in turn, is dependent upon our production volumes and commodity prices) which will be used primarily for the development of our current properties as well as to drill and complete the wells that were in progress at the end of 2006. This drilling program will be funded by cash flow from operations, availability under our revolving credit facility and if necessary, equity financing. Our ability to complete this drilling program may also be limited due to the lack of availability of drilling rigs and other equipment.

Markets and Customers

The revenue generated by our operations is highly dependent upon the prices of, and demand for, natural gas and crude oil. Historically, the markets for natural gas and crude oil have been volatile and are likely to continue to be volatile in the future. The prices we receive for our natural gas and crude oil production are subject to wide fluctuations and depend on numerous factors beyond our control including seasonality, the condition of the United States economy (particularly the manufacturing sector), foreign imports, political conditions in other crude oil-producing and natural gas-producing countries, the actions of the Organization of Petroleum Exporting Countries and domestic regulation, legislation and policies. Decreases in the prices of natural gas and crude oil have had, and could have in the future, an adverse effect on the carrying value of our proved reserves and our revenue, profitability and cash flow from operations. You should read the discussion under "Risk Factors - Risks Relating to Our Industry -- Market conditions for natural gas and crude oil, and particularly volatility of prices for natural gas and crude oil, could adversely affect our revenue, cash flows, profitability and growth" and "Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies" for more information relating to the effects of decreases in natural gas and crude oil prices on us. To help mitigate the impact of commodity price volatility, we hedge our production through the use of price floors. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - General - Commodity Prices and Hedging Activities" and Note 12 of the notes to our consolidated financial statements for more information regarding our hedging activities.

Substantially all of our natural gas and crude oil is sold at current market prices under short-term arrangements, as is customary in the industry. During the year ended December 31, 2006, two purchasers accounted for approximately 49% of our natural gas and crude oil sales. We believe that there are numerous other companies available to purchase our natural gas and crude oil and that the loss of one or more of these purchasers would not materially affect our ability to sell natural gas and crude oil.

Regulation of Natural Gas and Crude Oil Activities

The exploration, production and transportation of all types of hydrocarbons are subject to significant governmental regulations. Our operations are affected from time to time in varying degrees by political developments and federal, state and local laws and regulations. In particular, crude oil and natural gas production operations and economics are, or in the past have been, affected by industry specific price controls, taxes, conservation, safety, environmental, and other laws relating to the petroleum industry, and by changes in such laws and by constantly changing administrative regulations.

Price Regulations

In the past, maximum selling prices for certain categories of crude oil, natural gas, condensate and NGLs were subject to significant federal regulation. At the present time, however, all sales of our crude oil, natural gas and condensate produced under private contracts may be sold at market prices. Congress could, however, re-enact price controls in the future. If controls that limit prices to below market rates are instituted, our revenue could be adversely affected.

Natural Gas Regulation

Historically, the natural gas industry as a whole has been more heavily regulated than the crude oil or other liquid hydrocarbons market. Most regulations focused on transportation practices. Currently, the Federal Energy Regulatory Commission ("FERC), requires each interstate pipeline to, among other things, "unbundle" its traditional bundled sales services and create and make available on an open and nondiscriminatory basis numerous constituent services (such as gathering services, storage services, firm and interruptible transportation services, and standby sales and natural gas balancing services), and to adopt a new ratemaking methodology to determine appropriate rates for those services. To the extent the pipeline company or its sales affiliate markets natural gas as a merchant, it does so pursuant to private contracts in direct competition with all of the sellers, such as us; however, pipeline companies and their affiliates are not required to remain "merchants" of natural gas, and most of the interstate pipeline companies have become "transporters only", although many have affiliated marketers.

Transportation pipeline availability and shipping cost are major factors affecting the production and sale of natural gas. Our physical sales of natural gas are affected by the actual availability, terms and cost of pipeline transportation. The price and terms for access into the pipeline transportation systems remain subject to extensive Federal regulation. Although FERC does not directly regulate our production and marketing activities, it does affect how buyers and sellers gain access to and use of the necessary transportation facilities and how we and our competitors sell natural gas in the marketplace. FERC continues to review and modify its regulations regarding the transportation of natural gas. The 2005 Energy Policy Act recently authorized FERC to allow natural gas companies subject to the FERC's Natural Gas Act jurisdiction to provide gas storage and storage-related services at market-based rates for new storage capacity of a storage facility placed in service after the date of the Act's August 2005 passage, thereby enhancing competition in the market for interstate natural gas storage service.

In recent years FERC also has pursued a number of important policy initiatives which could significantly affect the marketing of natural gas in the United States. Most of these initiatives are intended to enhance competition in natural gas markets. FERC rules encouraging "spin downs", or the breakout of unregulated gathering activities from regulated transportation services, may have the adverse effect of increasing the cost of doing business on some in the industry, including us, as a result of the geographic monopolization of certain facilities by their new, unregulated owners. Note, however, that FERC is pursuing an inquiry into whether it should revise its test for determining whether and under what circumstances FERC may reassert jurisdiction over natural gas gathering companies that have been "spun-down" from an affiliated interstate natural gas pipeline to prevent abusive practices by the gatherer and its pipeline affiliate. Any action taken by FERC in this proceeding will be intended by it to enhance competition in the gas transportation sector. As to all FERC initiatives, the ongoing, or, in some instances, preliminary and evolving nature

of such matters makes it impossible at this time to predict their ultimate impact on our business. However, we do not believe that any FERC initiatives will affect us any differently than other natural gas producers and marketers with which we compete.

FERC decisions involving onshore facilities are more liberal in their reliance upon traditional tests for determining what facilities are "gathering" and therefore are exempt from federal regulatory control. In many instances, what was in the past classified as "transmission" may now be classified as "gathering." We ship certain of our natural gas through gathering facilities owned by others. Although FERC decisions create the potential for increasing the cost of shipping our natural gas on third party gathering facilities, our shipping activities have not been materially affected by these decisions.

In summary, all FERC activities related to the transportation of natural gas result in improved opportunities to market our physical production to a variety of buyers and market places, while at the same time increasing access to pipeline transportation and delivery services. Additional proposals and proceedings that might affect the natural gas industry in the United States are considered from time to time by Congress, FERC, state regulatory bodies and the courts. We cannot predict when or if any such proposals might become effective or their effect, if any, on our operations. The natural gas and crude oil industry historically has been very heavily regulated; thus there is no assurance that the less stringent regulatory approach recently pursued by FERC and Congress will continue indefinitely into the future.

State and Other Regulation

All of the jurisdictions in which we own producing natural gas and crude oil properties have statutory provisions regulating the exploration for and production of natural gas and crude oil. These include provisions requiring permits for the drilling of wells and maintaining bonding requirements in order to drill or operate wells and provisions relating to the location of wells, the method of drilling and casing wells, the surface use and restoration of properties upon which wells are drilled and the plugging and abandoning of wells. Our operations are also subject to various conservation laws and regulations. These include the regulation of the size of drilling and spacing units or proration units on an acreage basis and the density of wells which may be drilled and the unitization or pooling of natural gas and crude oil properties. In this regard, some states allow the forced pooling or integration of tracts to facilitate exploration while other states rely on voluntary pooling of lands and leases. In addition, state conservation laws establish maximum rates of production from natural gas and crude oil wells, generally prohibit the venting or flaring of natural gas and impose certain requirements regarding the ratability of production. Some states, such as Texas and Oklahoma, have, in recent years, reviewed and substantially revised methods previously used to make monthly determinations of allowable rates of production from fields and individual wells. The effect of all of these conservation regulations has the potential to limit the speed, timing and amounts of crude oil and natural gas we can produce from our wells, and to limit the number of wells or the location at which we can drill.

State regulation of gathering facilities generally includes various safety, environmental, and in some circumstances, non-discriminatory take or service requirements, but does not generally entail rate regulation. In the United States, natural gas gathering has received greater regulatory scrutiny at both the state and federal levels in the wake of the interstate pipeline restructuring under FERC Order 636. For example, the Texas Railroad Commission enacted a Natural Gas Transportation Standards and Code of Conduct to provide regulatory support for the State's more active review of rates, services and practices associated with the gathering and transportation of natural gas by an entity that provides such services to others for a fee, in order to prohibit such entities from unduly discriminating in favor of their affiliates.

For those operations on Federal or Indian oil and gas leases, such operations must comply with numerous regulatory restrictions, including various non-discrimination statutes, and certain of such operations must be conducted pursuant to certain on-site security regulations and other permits issued by various federal agencies. In addition, on Federal Lands in the United States, the Minerals Management Service ("MMS") prescribes or severely limits the types of costs that are deductible transportation costs for purposes of royalty valuation of production sold off the lease. In particular, MMS prohibits deduction of costs associated with marketer fees, cash out and other pipeline imbalance penalties, or long-term storage fees. Further, the MMS has been engaged in a process of promulgating new rules and procedures for determining the value of crude oil produced from federal lands for purposes of calculating royalties owed to the government. The natural gas and crude oil industry as a

whole has resisted the proposed rules under an assumption that royalty burdens will substantially increase. We cannot predict what, if any, effect any new rule will have on our operations.

Environmental Matters

Our operations are subject to numerous federal, state and local laws and regulations controlling the generation, use, storage, and discharge of materials into the environment or otherwise relating to the protection of the environment. These laws and regulations may require the acquisition of a permit or other authorization before construction or drilling commences; restrict the types, quantities, and concentrations of various substances that can be released into the environment in connection with drilling, production, and natural gas processing activities; suspend, limit or prohibit construction, drilling and other activities in certain lands lying within wilderness, wetlands, and other protected areas; require remedial measures to mitigate pollution from historical and on-going operations such as use of pits and plugging of abandoned wells; restrict injection of liquids into subsurface strata that may contaminate groundwater; and impose substantial liabilities for pollution resulting from our operations. Environmental permits required for our operations may be subject to revocation, modification, and renewal by issuing authorities. Governmental authorities have the power to enforce compliance with their regulations and permits, and violations are subject to injunction, civil fines, and even criminal penalties. Our management believes that we are in substantial compliance with current environmental laws and regulations, and that we will not be required to make material capital expenditures to comply with existing laws. Nevertheless, changes in existing environmental laws and regulations or interpretations thereof could have a significant impact on us as well as the natural gas and crude oil industry in general, and thus we are unable to predict the ultimate cost and effects of future changes in environmental laws and regulations.

We are not currently involved in any administrative, judicial or legal proceedings arising under domestic or foreign federal, state, or local environmental protection laws and regulations, or under federal or state common law, which would have a material adverse effect on our financial position or results of operations. Moreover, we maintain insurance against costs of clean-up operations, but we are not fully insured against all such risks. A serious incident of pollution may result in the suspension or cessation of operations in the affected area.

Superfund. The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), also known as "Superfund," and comparable state statutes impose strict, joint, and several liability on certain classes of persons who are considered to have contributed to the release of a "hazardous substance" into the environment. These persons include the owner or operator of a disposal site or sites where a release occurred and companies that generated, disposed or arranged for the disposal of the hazardous substances released at the site. Under CERCLA, such persons or companies may be retroactively liable for the costs of cleaning up the hazardous substances that have been released into the environment and for damages to natural resources, and it is common for neighboring land owners and other third parties to file claims for personal injury, property damage, and recovery of response costs allegedly caused by the hazardous substances released into the environment. In the course of our ordinary operations, we may generate waste that may fall within CERCLA's definition of a "hazardous substance." We may be jointly and severally liable under CERCLA or comparable state statutes for all or part of the costs required to clean up sites at which these wastes have been disposed. Although CERCLA currently contains a "petroleum exclusion" from the definition of "hazardous substance," state laws affecting our operations impose cleanup liability relating to petroleum and petroleum related products, including crude oil cleanups. In addition, although RCRA regulations currently classify certain oilfield wastes which are uniquely associated with field operations as "non-hazardous," such exploration, development and production wastes could be reclassified by regulation as hazardous wastes thereby administratively making such wastes subject to more stringent handling and disposal requirements.

We currently own or lease, and have in the past owned or leased, numerous properties that for many years have been used for the exploration and production of natural gas and crude oil. Although we utilized standard industry operating and disposal practices at the time, hydrocarbons or other wastes may have been disposed of or released on or under the properties we owned or leased or on or under other locations where such wastes have been taken for disposal. In addition, many of these properties have been operated by third parties whose treatment and disposal or release of hydrocarbons or other wastes was not under our control. These properties and the wastes disposed thereon may be subject to CERCLA, RCRA (as defined below), and analogous state laws. Under these laws, we could be required to remove or remediate previously disposed wastes, including

wastes disposed or released by prior owners or operators; to clean up contaminated property, including contaminated groundwater; or to perform remedial operations to prevent future contamination.

Oil Pollution Act of 1990. United States federal regulations also require certain owners and operators of facilities that store or otherwise handle crude oil, such as us, to prepare and implement spill prevention, control and countermeasure plans and spill response plans relating to possible discharge of crude oil into surface waters. The federal Oil Pollution Act ("OPA") contains numerous requirements relating to prevention of, reporting of, and response to crude oil spills into waters of the United States. For facilities that may affect state waters, OPA requires an operator to demonstrate $10 million in financial responsibility. State laws mandate crude oil cleanup programs with respect to contaminated soil. A failure to comply with OPA's requirements or inadequate cooperation during a spill response action may subject a responsible party to civil or criminal enforcement actions. We are not aware of any action or event that would subject us to liability under OPA, and we believe that compliance with OPA's financial responsibility and other operating requirements will not have a material adverse effect on us.

U.S. Environmental Protection Agency. U.S. Environmental Protection Agency regulations address the disposal of crude oil and natural gas operational wastes under three federal acts more fully discussed in the paragraphs that follow. The Resource Conservation and Recovery Act of 1976, as amended ("RCRA"), provides a framework for the safe disposal of discarded materials and the management of solid and hazardous wastes. The direct disposal of operational wastes into offshore waters is also limited under the authority of the Clean Water Act. When injected underground, crude oil and natural gas wastes are regulated by the Underground Injection Control program under the Safe Drinking Water Act. If wastes are classified as hazardous, they must be properly transported, using a uniform hazardous waste manifest, documented, and disposed of at an approved hazardous waste facility. We have coverage under the applicable Clean Water Act permitting requirements for discharges associated with exploration and development activities.

Resource Conservation Recovery Act. RCRA is the principal federal statute governing the treatment, storage and disposal of hazardous wastes. RCRA imposes stringent operating requirements, and liability for failure to meet such requirements, on a person who is either a "generator" or "transporter" of hazardous waste or an "owner" or "operator" of a hazardous waste treatment, storage or disposal facility. At present, RCRA includes a statutory exemption that allows most crude oil and natural gas exploration and production waste to be classified as nonhazardous waste. A similar exemption is contained in many of the state counterparts to RCRA. As a result, we are not required to comply with a substantial portion of RCRA's requirements because our operations generate minimal quantities of hazardous wastes. At various times in the past, proposals have been made to amend RCRA to rescind the exemption that excludes crude oil and natural gas exploration and production wastes from regulation as hazardous waste. Repeal or modification of the exemption by administrative, legislative or judicial process, or modification of similar exemptions in applicable state statutes, would increase the volume of hazardous waste we are required to manage and dispose of and would cause us to incur increased operating expenses.

Clean Water Act. The Clean Water Act imposes restrictions and controls on the discharge of produced waters and other wastes into navigable waters. Permits must be obtained to discharge pollutants into state and federal waters and to conduct construction activities in waters and wetlands. Certain state regulations and the general permits issued under the Federal National Pollutant Discharge Elimination System program prohibit the discharge of produced waters and sand, drilling fluids, drill cuttings and certain other substances related to the crude oil and natural gas industry into certain coastal and offshore waters. Further, the EPA has adopted regulations requiring certain crude oil and natural gas exploration and production facilities to obtain permits for storm water discharges. Costs may be associated with the treatment of wastewater or developing and implementing storm water pollution prevention plans. The Clean Water Act and comparable state statutes provide for civil, criminal and administrative penalties for unauthorized discharges for crude oil and other pollutants and impose liability on parties responsible for those discharges for the costs of cleaning up any environmental damage caused by the release and for natural resource damages resulting from the release. We believe that our operations comply in all material respects with the requirements of the Clean Water Act and state statutes enacted to control water pollution.

Safe Drinking Water Act. Underground injection is the subsurface placement of fluid through a well, such as the reinjection of brine produced and separated from crude oil and natural gas production. The Safe Drinking Water Act of 1974, as amended establishes a regulatory framework for underground injection, with the main goal being the protection of usable aquifers. The primary objective of injection well operating requirements is to ensure the mechanical integrity of the injection apparatus and to prevent migration of fluids from the injection

zone into underground sources of drinking water. Hazardous-waste injection well operations are strictly controlled, and certain wastes, absent an exemption, cannot be injected into underground injection control wells. In Texas, no underground injection may take place except as authorized by permit or rule. We currently own and operate various underground injection wells. Failure to abide by our permits could subject us to civil and/or criminal enforcement. We believe that we are in compliance in all material respects with the requirements of applicable state underground injection control programs and our permits.

Air Pollution Control. The Clean Air Act and state air pollution laws adopted to fulfill its mandate provide a framework for national, state and local efforts to protect air quality. Our operations utilize equipment that emits air pollutants which may be subject to federal and state air pollution control laws. These laws require utilization of air emissions abatement equipment to achieve prescribed emissions limitations and ambient air quality standards, as well as operating permits for existing equipment and construction permits for new and modified equipment. We believe that we are in compliance in all material respects with the requirements of applicable federal and state air pollution control laws.

Naturally Occurring Radioactive Materials ("NORM"). NORM are materials not covered by the Atomic Energy Act, whose radioactivity is enhanced by technological processing such as mineral extraction or processing through exploration and production conducted by the crude oil and natural gas industry. NORM wastes are regulated under the RCRA framework, but primary responsibility for NORM regulation has been a state function. Standards have been developed for worker protection; treatment, storage and disposal of NORM waste; management of waste piles, containers and tanks; and limitations upon the release of NORM contaminated land for unrestricted use. We believe that our operations are in material compliance with all applicable NORM standards established by the State of Texas.

Abandonment Costs. All of our crude oil and natural gas wells will require proper plugging and abandonment when they are no longer producing. We post bonds with most regulatory agencies to ensure compliance with our plugging responsibility. Plugging and abandonment operations and associated reclamation of the surface production site are important components of our environmental management system. We plan accordingly for the ultimate disposition of properties that are no longer producing.

Title to Properties

As is customary in the natural gas and crude oil industry, we make only a cursory review of title to undeveloped natural gas and crude oil leases at the time we acquire them. However, before drilling commences, we require a thorough title search to be conducted, and any material defects in title are remedied prior to the time actual drilling of a well begins. To the extent title opinions or other investigations reflect title defects, we, rather than the seller/lessor of the undeveloped property, are typically obligated to cure any title defect at our expense. If we were unable to remedy or cure any title defect of a nature such that it would not be prudent to commence drilling operations on the property, we could suffer a loss of our entire investment in the property. We believe that we have good title to our natural gas and crude oil properties, some of which are subject to immaterial encumbrances, easements and restrictions. The natural gas and crude oil properties we own are also typically subject to royalty and other similar non-cost bearing interests customary in the industry. We do not believe that any of these encumbrances or burdens will materially affect our ownership or use of our properties.

Competition

We operate in a highly competitive environment. The principal resources necessary for the exploration and production of natural gas and crude oil are leasehold prospects under which natural gas and crude oil reserves may be discovered, drilling rigs and related equipment to explore for such reserves and knowledgeable personnel to conduct all phases of natural gas and crude oil operations. We must compete for such resources with both major natural gas and crude oil companies and independent operators. Many of these competitors have financial and other resources substantially greater than ours. Although we believe our current operating and financial resources are adequate to preclude any significant disruption of our operations in the immediate future, we cannot assure you that such materials and resources will be available to us. For more information, you should read "Risk Factors - Risks Related to Our Industry - We operate in a highly competitive industry which may adversely affect our operations." and "- The unavailability or high cost of drilling rigs, equipment, supplies, insurance, personnel and crude oil field services could adversely affect our ability to execute our exploration and development plans on a timely basis and within our budget."

Employees

As of March 9, 2007 we had 50 full-time employees in the United States, including two executive officers, three non-executive officers, one petroleum engineer, one geologist, five managers, one landman, eleven administrative and support personnel and 26 field personnel. Additionally, we retain contract gaugers on a month-to-month basis. We retain independent geological and engineering consultants from time to time on a limited basis and expect to continue to do so in the future.

Available Information

We file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission. You may read and copy any document we file with the SEC at the SEC's public reference room at 100 F Street, NE, Room 1580, Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for information on the public reference room. The SEC maintains an internet web site that contains annual, quarterly and current reports, proxy statements and other information that issuers (including Abraxas) file electronically with the SEC. The SEC's web site is www.sec.gov.

Our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and other reports and amendments filed with the Securities and Exchange Commission are available free of charge on our web site at www.abraxaspetroleum.com in the Investor Relations section as soon as practicable after such reports are filed. Information on our website is not incorporated by reference into this Form 10-K and should not be considered part of this report or any other filing that we make with the SEC.

Item 1A. Risk Factors

Risks Related to Our Business

We have a highly leveraged capital structure, which limits our operating and financial flexibility.

We have a highly leveraged capital structure. At March 9, 2007, we had total indebtedness, including our floating rate senior secured notes due 2009, or notes, of approximately $127.3 million, all of which is secured indebtedness. We also had availability of $12.7 million under our $15.0 million senior secured revolving credit facility, all of which is also secured indebtedness.

Our highly leveraged capital structure will have several important affects on our future operations, including:

- a substantial amount of our cash flow from operations will be required to service our indebtedness, which will reduce the funds that would otherwise be available for operations, capital expenditures and expansion opportunities, including developing our properties;

- the covenants contained in our revolving credit facility require us to meet certain financial tests and comply with certain other restrictions, including limitations on capital expenditures. These restrictions, together with those in the indenture governing the notes, may limit our ability to undertake certain activities and respond to changes in our business and our industry;

- our debt level may impair our ability to obtain additional capital, through equity offerings or debt financings, for working capital, capital expenditures, or refinancing of indebtedness;

- our debt level makes us more vulnerable to economic downturns and adverse developments in our industry (especially declines in natural gas and crude oil prices) and the economy in general; and

- the notes and our revolving credit facility are subject to variable interest rates which makes us vulnerable to interest rate increases.

We may not be able to fund the substantial capital expenditures that will be required for us to increase our reserves and our production.

We are required to make substantial capital expenditures to develop our existing reserves and to discover new reserves. Historically, we have financed our capital expenditures primarily with cash flow from operations, borrowings under credit facilities, sales of producing properties, and sales of equity securities and we expect to continue to do so in the future; however, we cannot assure you that we will have sufficient capital resources in the future to finance all of our capital expenditures.

Volatility in natural gas and crude oil prices, the timing of our drilling program and our drilling results will affect our cash flow from operations. Lower prices and/or lower production will also decrease revenues and cash flow, thus reducing the amount of financial resources available to meet our capital requirements, including reducing the amount available to pursue our drilling opportunities. If our cash flow from operations does not increase as a result of our planned capital expenditures, a greater percentage of our cash flow from operations will be required for debt service and our planned capital expenditures would, by necessity, be decreased.

The borrowing base under our revolving credit facility will be determined from time to time by our lenders, consistent with their customary natural gas and crude oil lending practices. Reductions in estimates of our natural gas and crude oil reserves could result in a reduction in our borrowing base, which would reduce the amount of financial resources available under our revolving credit facility to meet our capital requirements. Such a reduction could be the result of lower commodity prices or production, inability to drill or unfavorable drilling results, changes in natural gas and crude oil reserve engineering, the lenders' inability to agree to an adequate borrowing base or adverse changes in the lenders' practices regarding estimation of reserves.

If cash flow from operations or our borrowing base decrease for any reason, our ability to undertake exploration and development activities could be adversely affected. As a result, our ability to replace production may be limited. In addition, if the borrowing base under our revolving credit facility is reduced, we would be required to reduce our borrowings under our revolving credit facility so that such borrowings do not exceed the borrowing base. This could further reduce the cash available to us for capital spending and, if we did not have sufficient capital to reduce our borrowing level, could cause us to default under our revolving credit facility and the notes.

We have sold producing properties to provide us with liquidity and capital resources in the past, including during 2006, and may do so in the future. After any such sale, we would expect to utilize the proceeds to drill new wells. If we cannot replace the production lost from properties sold with production from new properties, our cash flow from operations will likely decrease which, in turn, would decrease the amount of cash available for debt service and additional capital spending.

We may be unable to acquire or develop additional reserves, in which case our results of operations and financial condition would be adversely affected.

Our future natural gas and crude oil production, and therefore our success, is highly dependent upon our ability to find, acquire and develop additional reserves that are profitable to produce. The rate of production from our natural gas and crude oil properties and our proved reserves will decline as our reserves are produced unless we acquire additional properties containing proved reserves, conduct successful development and exploration activities or, through engineering studies, identify additional behind-pipe zones or secondary recovery reserves. We cannot assure you that our exploration and development activities will result in increases in our proved reserves. For example, in 2006, while we have had some success in pursuing these activities, we were not able to fully replace the production volumes lost from natural field declines and property sales. If our proved reserves continue to decline in the future, our production will also decline and, consequently, our cash flow from operations and the amount that we are able to borrow under our revolving credit facility will also decline. In addition, approximately 52% of our total estimated proved reserves at December 31, 2006 were undeveloped. By their nature, estimates of undeveloped reserves are less certain. Recovery of such reserves will require significant capital expenditures and successful drilling operations.

A substantial portion of our production is currently concentrated in one well.

Approximately 29% of our production during 2006 was from a single well in west Texas. Like all natural gas wells, the rate of production from this well will decline over time and the reserves associated with this well will also decrease. If production from this well decreases, and if we are unable to reduce the percentage of our production represented by this well, it would have a

material adverse effect on our revenues, cash flow from operations and financial condition. This well is subject to all of the risks typically associated with natural gas wells, including depletion and the risks described in "Risks Related to Our Industry - Our operations are subject to the numerous risks of natural gas and crude oil drilling and production activities."

We may not find any commercially productive natural gas or crude oil reservoirs.

We cannot assure you that the new wells we drill will be productive or that we will recover all or any portion of our capital investment. Drilling for natural gas and crude oil may be unprofitable. Dry holes and wells that are productive but do not produce sufficient net revenues after drilling, operating and other costs are unprofitable. The inherent risk of not finding commercially productive reservoirs will be compounded by the fact that 52% of our total estimated proved reserves at December 31, 2006 were undeveloped. By their nature, estimates of undeveloped reserves are less certain. Recovery of such reserves will require significant capital expenditures and successful drilling operations. In addition, our properties may be susceptible to drainage from production by other operations on adjacent properties. If the volume of natural gas and crude oil we produce decreases, our cash flow from operations will decrease.

Restrictive debt covenants could limit our growth and our ability to finance our operations, fund our capital needs, respond to changing conditions and engage in other business activities that may be in our best interest.

Our revolving credit facility and the indenture governing the notes contain a number of significant covenants that, among other things, limit our ability to:

- incur or guarantee additional indebtedness and issue certain types of preferred stock or redeemable stock;
- transfer or sell assets;
- create liens on assets;
- pay dividends or make other distributions on capital stock or make other restricted payments, including repurchasing, redeeming

or retiring capital stock or subordinated debt or making certain investments or acquisitions;

- engage in transactions with affiliates;
- guarantee other indebtedness;
- make any change in the principal nature of our business;
- prepay, redeem, purchase or otherwise acquire any of our or our restricted subsidiaries' indebtedness;
- permit a change of control;
- directly or indirectly make or acquire any investment;
- cause a restricted subsidiary to issue or sell our capital stock; and
- consolidate, merge or transfer all or substantially all of the consolidated assets of Abraxas and our restricted subsidiaries.

In addition, our revolving credit facility requires us to maintain compliance with specified financial ratios and satisfy certain financial condition tests. Our ability to comply with these ratios and financial condition tests may be affected by events beyond our control, and we cannot assure you that we will meet these ratios and financial condition tests. These financial ratio restrictions and financial condition tests could limit our ability to obtain future financings, make needed capital expenditures, withstand a future downturn in our business or the economy in general or otherwise conduct necessary or desirable corporate activities.

A breach of any of these covenants or our inability to comply with the required financial ratios or financial condition tests could result in a default

under our revolving credit facility and the notes. A default, if not cured or waived, could result in all of our indebtedness, including the notes, becoming immediately due and payable. If that should occur, we may not be able to pay all such debt or to borrow sufficient funds to refinance it. Even if new financing were then available, it may not be on terms that are acceptable to us.

The marketability of our production depends largely upon the availability, proximity and capacity of natural gas gathering systems, pipelines and processing facilities.

The marketability of our production depends in part upon processing and transportation facilities. Transportation space on such gathering systems and pipelines is occasionally limited and at times unavailable due to repairs or improvements being made to such facilities or due to such space being utilized by other companies with priority transportation agreements. Our access to transportation options can also be affected by U.S. Federal and state regulation of natural gas and crude oil production and transportation, general economic conditions and changes in supply and demand. These factors and the availability of markets are beyond our control. If market factors dramatically change, the financial impact on us could be substantial and adversely affect our ability to produce and market natural gas and crude oil.

Hedging transactions have in the past and may in the future impact our cash flow from operations.

We enter into hedging arrangements from time to time to reduce our exposure to fluctuations in natural gas and crude oil prices and to achieve more predictable cash flow. In 2005, we incurred a hedging loss of $592,000, resulting from the price floors we established. For the year ended December 31, 2004 and 2006, we recognized a gain from hedging activities of approximately $118,000 and $646,000 respectively. Currently, we believe our hedging arrangements, which are in the form of price floors, do not expose us to significant financial risk.

We cannot assure you that the hedging transactions we have entered into, or will enter into, will adequately protect us from financial loss in the future due to circumstances such as:

- o highly volatile natural gas and crude oil prices;
- o our production being less than expected; or
- o a counterparty to one of our hedging transactions defaulting on its contractual obligations.

Lower natural gas and crude oil prices increase the risk of ceiling limitation write-downs.

We use the full cost method to account for our natural gas and crude oil operations. Accordingly, we capitalize the cost to acquire, explore for and develop natural gas and crude oil properties. Under full cost accounting rules, the net capitalized cost of natural gas and crude oil properties may not exceed a "ceiling limit" which is based upon the present value of estimated future net cash flows from proved reserves, discounted at 10%. If net capitalized costs of natural gas and crude oil properties exceed the ceiling limit, we must charge the amount of the excess to earnings. This is called a "ceiling limitation write-down." This charge does not impact cash flow from operating activities, but does reduce our stockholders' equity and earnings. The risk that we will be required to write-down the carrying value of natural gas and crude oil properties increases when natural gas and crude oil prices are low. In addition, write-downs may occur if we experience substantial downward adjustments to our estimated proved reserves. An expense recorded in one period may not be reversed in a subsequent period even though higher natural gas and crude oil prices may have increased the ceiling applicable to the subsequent period.

We have incurred ceiling limitation write-downs in the past. We cannot assure you that we will not experience additional ceiling limitation write-downs in the future.

Use of our net operating loss carryforwards may be limited.

At December 31, 2006, we had, subject to the limitation discussed below, $192.7 million of net operating loss carryforwards for U.S. tax purposes. These loss carryforwards will expire through 2026 if not utilized. In addition, as to a portion of the U.S. net operating loss carryforwards, the amount of such carryforwards that we can use annually is limited under U.S. tax law. Moreover, uncertainties exist as to the future utilization of the operating loss carryforwards under the criteria set forth under FASB Statement No. 109.

Therefore, we have established a valuation allowance of $66.9 for deferred tax assets at December 31, 2005 and 2006.

We depend on our Chairman, President and CEO and the loss of his services could have an adverse effect on our operations.

We depend to a large extent on Robert L. G. Watson, our Chairman of the Board, President and Chief Executive Officer, for our management and business and financial contacts. Mr. Watson may terminate his employment agreement with us at any time on 30 days notice, but, if he terminates without cause, he would not be entitled to the severance benefits provided under the terms of that agreement. Mr. Watson is not precluded from working for, with or on behalf of a competitor upon termination of his employment with us. If Mr. Watson were no longer able or willing to act as our Chairman, the loss of his services could have an adverse effect on our operations. In addition, in connection with the initial public offering by our previously wholly-owned subsidiary, Grey Wolf Exploration Inc., we, Grey Wolf and Mr. Watson agreed that Mr. Watson would continue to serve as our Chief Executive Officer and President and as the Chief Executive Officer for Grey Wolf, with Mr. Watson devoting two-thirds of his time to his positions and duties with us and one-third of his time to his position and duties with Grey Wolf. In consideration for receiving Mr. Watson's services, Grey Wolf makes an annual payment to Abraxas of US$100,000 and reimburses Abraxas for Mr. Watson's expenses incurred in connection with providing such services.

Risks Related to Our Industry

Market conditions for natural gas and crude oil, and particularly volatility of prices for natural gas and crude oil, could adversely affect our revenue, cash flows, profitability and growth.

Our revenue, cash flows, profitability and future rate of growth depend substantially upon prevailing prices for natural gas and crude oil. Natural gas prices affect us more than crude oil prices because most of our production and reserves are natural gas. Prices also affect the amount of cash flow available for capital expenditures and our ability to borrow money or raise additional capital. Lower prices may also make it uneconomical for us to increase or even continue current production levels of natural gas and crude oil.

Prices for natural gas and crude oil are subject to large fluctuations in response to relatively minor changes in the supply and demand for natural gas and crude oil, market uncertainty and a variety of other factors beyond our control, including:

- changes in foreign and domestic supply and demand for natural gas and crude oil;
- political stability and economic conditions in oil producing countries, particularly in the Middle East;
- general economic conditions;
- domestic and foreign governmental regulation; and
- the price and availability of alternative fuel sources.

In addition to decreasing our revenue and cash flow from operations, low or declining natural gas and crude oil prices could have additional material adverse effects on us, such as:

- reducing the overall volume of natural gas and crude oil that we can produce economically, thereby adversely affecting our revenue, profitability and cash flow and our ability to perform our obligations with respect to the notes;

- o reducing our borrowing base under the credit facility; and
- o impairing our borrowing capacity and our ability to obtain equity capital.

Estimates of our proved reserves and future net revenue are uncertain and inherently imprecise.

The process of estimating natural gas and crude oil reserves is complex involving decisions and assumptions in evaluating the available geological, geophysical, engineering and economic data. Accordingly, these estimates are

imprecise. Actual future production, natural gas and crude oil prices, revenues, taxes, development expenditures, operating expenses and quantities of recoverable natural gas and crude oil reserves most likely will vary from those estimated. Any significant variance could materially affect the estimated quantities and present value of reserves set forth in this report. In addition, we may adjust estimates of proved reserves to reflect production history, results of exploration and development, prevailing natural gas and crude oil prices and other factors, many of which are beyond our control.

The estimates of our reserves are based upon various assumptions about future production levels, prices and costs that may not prove to be correct over time. In particular, estimates of natural gas and crude oil reserves, future net revenue from proved reserves and the PV-10 thereof for our natural gas and crude oil properties are based on the assumption that future natural gas and crude oil prices remain the same as natural gas and crude oil prices at December 31, 2006. The sales prices as of such date used for purposes of such estimates were $5.83 per Mcf of natural gas and $56.42 per Bbl of crude oil. This compares with $8.84 per Mcf of natural gas and $56.92 per Bbl of crude oil as of December 31, 2005. These estimates also assume that we will make future capital expenditures of approximately $83.0 million in the aggregate through 2026, with the majority expected to be incurred from 2007 to 2012, which are necessary to develop and realize the value of proved undeveloped reserves on our properties. Any significant variance in actual results from these assumptions could also materially affect the estimated quantity and value of reserves set forth in this report.

The present value of future net revenues we disclose may not be the current market value of our estimated natural gas and crude oil reserves. In accordance with SEC requirements, the estimated discounted future net cash flows from proved reserves are generally based on prices and costs as of the end of the period of the estimate. Actual future prices and costs may be materially higher or lower than the prices and costs as of the end of the year of the estimate. Any changes in consumption by natural gas purchasers or in governmental regulations or taxation will also affect actual future net cash flows. The timing of both the production and the expenses from the development and production of natural gas and crude oil properties will affect the timing of actual future net cash flows from proved reserves and their present value. In addition, the 10% discount factor, which is required by the SEC to be used in calculating discounted future net cash flows for reporting purposes, is not necessarily the most accurate discount factor. The effective interest rate at various times and the risks associated with us or the natural gas and crude oil industry in general will affect the accuracy of the 10% discount factor.

Our operations are subject to the numerous risks of natural gas and crude oil drilling and production activities.

Our natural gas and crude oil drilling and production activities are subject to numerous risks, many of which are beyond our control. These risks include the risk of fire, explosions, blow-outs, pipe failure, abnormally pressured formations and environmental hazards. Environmental hazards include oil spills, natural gas leaks, ruptures and discharges of toxic gases. In addition, title problems, weather conditions and mechanical difficulties or shortages or delays in delivery of drilling rigs and other equipment could negatively affect our operations. If any of these or other similar industry operating risks occur, we could have substantial losses. Substantial losses also may result from injury or loss of life, severe damage to or destruction of property, clean-up responsibilities, regulatory investigation and penalties and suspension of operations. In accordance with industry practice, we maintain insurance against some, but not all, of the risks described above. We cannot assure you that our insurance will be adequate to cover losses or liabilities. Also, we cannot predict the continued availability of insurance at premium levels that justify its purchase.

We operate in a highly competitive industry which may adversely affect our operations.

We operate in a highly competitive environment. The principal resources necessary for the exploration and production of natural gas and crude oil are leasehold prospects under which natural gas and crude oil reserves may be discovered, drilling rigs and related equipment to explore for such reserves and knowledgeable personnel to conduct all phases of natural gas and crude oil operations. We must compete for such resources with both major natural gas and crude oil companies and independent operators. Many of these competitors have financial and other resources substantially greater than ours. Although we believe our current operating and financial resources are adequate to preclude any significant disruption of our operations in the immediate future, we cannot assure you that such materials and resources will be available to us.

The unavailability or high cost of drilling rigs, equipment, supplies, insurance, personnel and crude oil field services could adversely affect our ability to execute our exploration and development plans on a timely basis and within our budget.

Our industry is cyclical and, from time to time, there is a shortage of drilling rigs, equipment, supplies, insurance or qualified personnel. During these periods, the costs and delivery times of rigs, equipment and supplies are substantially greater. In addition, the demand for, and wage rates of, qualified drilling rig crews rise as the number of active rigs in service increases. As a result of increasing levels of exploration and production in response to strong prices of natural gas and crude oil, the demand for oilfield services has risen and the costs of these services are increasing.

Our natural gas and crude oil operations are subject to various Federal, state and local regulations that materially affect our operations.

Matters regulated include permits for drilling operations, drilling and abandonment bonds, reports concerning operations, the spacing of wells and unitization and pooling of properties and taxation. At various times, regulatory agencies have imposed price controls and limitations on production. In order to conserve supplies of natural gas and crude oil, these agencies have restricted the rates of flow of natural gas and crude oil wells below actual production capacity. Federal, state and local laws regulate production, handling, storage, transportation and disposal of natural gas and crude oil, by-products from natural gas and crude oil and other substances and materials produced or used in connection with natural gas and crude oil operations. To date, our expenditures related to complying with these laws and for remediation of existing environmental contamination have not been significant. We believe that we are in substantial compliance with all applicable laws and regulations. However, the requirements of such laws and regulations are frequently changed. We cannot predict the ultimate cost of compliance with these requirements or their effect on our operations.

Risks Related to the Common Stock

We do not pay dividends on common stock.

We have never paid a cash dividend on our common stock and the terms of the revolving credit facility and the indenture relating to the notes limit our ability to pay dividends on our common stock.

Shares eligible for future sale may depress our stock price.

At March 9, 2007, we had 42,769,284 shares of common stock outstanding of which 3,628,078 shares were held by affiliates and, in addition, 2,467,716 shares of common stock were subject to outstanding options granted under certain stock option plans (of which 1,908,116 shares were vested at March 9, 2007).

All of the shares of common stock held by affiliates are restricted or controlled securities under Rule 144 promulgated under the Securities Act of 1933, as amended (the "Securities Act"). The shares of the common stock issuable upon exercise of the stock options have been registered under the Securities Act. Sales of shares of common stock under Rule 144 or another exemption under the Securities Act or pursuant to a registration statement could have a material adverse effect on the price of the common stock and could impair our ability to raise additional capital through the sale of equity securities.

The price of our common stock has been volatile and could continue to fluctuate substantially.

Our common stock is traded on The American Stock Exchange. The market price of our common stock has been volatile and could fluctuate substantially based on a variety of factors, including the following:

- fluctuations in commodity prices;
- variations in results of operations;
- legislative or regulatory changes;
- general trends in the industry;

- market conditions; and
- analysts' estimates and other events in the natural gas and crude oil industry.

We may issue shares of preferred stock with greater rights than our common stock.

Subject to the rules of The American Stock Exchange, our articles of incorporation authorize our board of directors to issue one or more series of preferred stock and set the terms of the preferred stock without seeking any further approval from holders of our common stock. Any preferred stock that is issued may rank ahead of our common stock in terms of dividends, priority and liquidation premiums and may have greater voting rights than our common stock.

Anti-takeover provisions could make a third party acquisition of Abraxas difficult.

Our articles of incorporation and bylaws provide for a classified board of directors, with each member serving a three-year term, and eliminate the ability of stockholders to call special meetings or take action by written consent. Each of the provisions in the articles of incorporation and bylaws could make it more difficult for a third party to acquire Abraxas without the approval of our board. In addition, the Nevada corporate statute also contains certain provisions that could make an acquisition by a third party more difficult.

An active market may not develop for our common stock.

Our common stock is quoted on The American Stock Exchange. While there is currently one specialist in our common stock, this specialist is not obligated to continue to make a market in our common stock. In this event, the liquidity of our common stock could be adversely impacted and a stockholder could have difficulty obtaining accurate stock quotes.

Future issuance of additional shares of our common stock could cause dilution of ownership interests and adversely affect our stock price.

We may in the future issue our previously authorized and unissued securities, resulting in the dilution of the ownership interests of our current stockholders. We are currently authorized to issue 200,000,000 shares of common stock with such rights as determined by our board of directors. The potential issuance of such additional shares of common stock may create downward pressure on the trading price of our common stock. We may also issue additional shares of our common stock or other securities that are convertible into or exercisable for common stock for capital raising or other business purposes. Future sales of substantial amounts of common stock, or the perception that sales could occur, could have a material adverse effect on the price of our common stock.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Primary Operating Areas

Texas

Our operations are concentrated in south and west Texas with over 99% of the PV-10 of our natural gas and crude oil properties at December 31, 2006 located in those two regions. We operate 93% of our wells in Texas. During 2006, we drilled a total of 5 new wells (4.2 net) in Texas with an 80% success rate. This drilling, although somewhat successful did not fully replace the production volumes lost from natural field declines and property sales. During 2006, we sold natural gas properties with reserves of 1.8 Bcfe and produced 7.7 Bcfe.

Operations in south Texas are concentrated along the Edwards trend in DeWitt and Lavaca Counties, the Frio/Vicksburg trend in San Patricio County and the Wilcox trend in Bee, Karnes, Goliad and DeWitt Counties. In south Texas, we own an average 94% working interest in 41 wells with average production of 205 net Bbls of crude oil and 5,759 net Mcf of natural gas per day for the year ended December 31, 2006. As of December 31, 2006, we had estimated net proved reserves in south Texas of 30.1 Bcfe (88% natural gas) with a PV-10 of $59.6 million, 61% of which was attributable to proved developed reserves.

Our west Texas operations are concentrated along the deep Devonian/Montoya/Ellenburger formations and shallow Cherry Canyon sandstones in Ward County, the Sharon Ridge Clearfork Field in Scurry and Mitchell Counties and Devonian, Woodford and Wolfcamp formations in Pecos County. We drilled one well in west Texas which was brought onto production in August 2005 that accounted for approximately 29% of our production in 2006.

In west Texas, we own an average 75% working interest in 169 wells with average daily production of 298 net Bbls of crude oil and 12,090 net Mcf of natural gas per day for the year ended December 31, 2006. As of December 31, 2006, we had estimated net proved reserves in west Texas of 67.6 Bcfe (82% natural gas) with a PV-10 of $99.6 million, 42% of which was attributable to proved developed reserves.

In the Abraxas Cherry Canyon Field of Ward County, Texas, we have two wells currently being completed in the Bell and Cherry Canyon sands. In the Oates SW Field of Pecos County, Texas, we have two wells which began drilling in 2006 and are still in progress and one well that is currently awaiting a drilling rig to drill the horizontal lateral in the Devonian formation.

Wyoming

We currently hold 50,409 acres in the Powder River Basin in east central Wyoming. We have drilled and operate ten wells in Converse and Niobrara counties that were completed in the Muddy, Mowry, Turner, and Niobrara formations. We own a 100% working interest in these wells that produced a combined average of 46 net barrels of crude oil per day in 2006. As of December 31, 2006, we had estimated net proved producing reserves in Wyoming of 169,640 barrels of crude oil with a PV-10 of $1.6 million.

During 2006, the wells that were drilled in late 2005 were fracture stimulated and brought onto production. In the Brooks Draw Field of Wyoming, we are currently in the process of permitting new horizontal Mowry Shale wells while monitoring industry activity in this new area. We plan to drill several more wells in Wyoming during 2007.

Exploratory and Developmental Acreage

Our principal natural gas and crude oil properties consist of non-producing and producing natural gas and crude oil leases, including reserves of natural gas and crude oil in place. The following table indicates our interest in developed and undeveloped acreage and fee mineral acreage as of December 31, 2006:

Developed Acreage (1)		Undeveloped Acreage (2)		Fee Mineral Acreage (3)	
Gross Acres (4)	Net Acres (5)	Gross Acres (4)	Net Acres (5)	Gross Acres (6)	Net Acres

South Texas	4,687	4,258	3,496	3,256	-	-
West Texas	20,868	15,616	17,752	12,617	12,007	5,272
Wyoming	3,400	3,400	47,009	43,111	-	-
N. Dakota	-	-	80	24	-	-
Total	28,955	23,274	68,337	59,008	12,007	5,272

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(1) Developed acreage consists of leased acres spaced or assignable to productive wells.
(2) Undeveloped acreage is considered to be those leased acres on which wells have not been drilled or completed to a point that would permit the production of commercial quantities of natural gas and crude oil, regardless of whether or not such acreage contains proved reserves.
(3) Fee mineral acreage represents fee simple absolute ownership of the mineral estate or fraction thereof.

(4) Gross acres refers to the number of acres in which we own a working interest.
(5) Net acres represents the number of acres attributable to an owner's proportionate working interest (e.g., a 50% working interest in a lease covering 320 acres is equivalent to 160 net acres).
(6) Includes 7,484 acres that are included in developed and undeveloped gross acres.

Productive Wells

The following table sets forth our total gross and net productive wells expressed separately for natural gas and crude oil, as of December 31, 2006:

Productive Wells (1)
As of December 31, 2006

State	Crude Oil		Natural Gas	
	Gross(2)	Net(3)	Gross(2)	Net(3)
South Texas	17.0	17.0	24.0	21.2
West Texas	133.0	103.4	36.0	23.5
Wyoming	10.0	10.0	-	-
Total	160.0	130.4	60.0	44.7

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(1) Productive wells are producing wells and wells capable of production.
(2) A gross well is a well in which we own an interest.
(3) A net well is deemed to exist when the sum of fractional ownership working interests in gross wells equals one.

Reserves Information

The natural gas and crude oil reserves have been estimated as of December 31, 2004, December 31, 2005, and December 31, 2006, by DeGolyer and MacNaughton, of Dallas, Texas. Natural gas and crude oil reserves, and the estimates of the present value of future net revenues there-from, were determined based on then current prices and costs. Reserve calculations involve the estimate of future net recoverable reserves of natural gas and crude oil and the timing and amount of future net revenues to be received therefrom. Such estimates are not precise and are based on assumptions regarding a variety of factors, many of which are variable and uncertain.

The following table sets forth certain information regarding estimates of our crude oil, natural gas liquids and natural gas reserves as of December 31, 2004, December 31, 2005 and December 31, 2006.

	Estimated Proved Reserves		
	Proved Developed	Proved Undeveloped	Tot Prov
As of December 31, 2004			
Crude oil (MBbls)	1,878	1,223	3
Natural gas (Mmcf)	36,241	38,877	75
As of December 31, 2005			
Crude oil (MBbls)	1,942	1,142	3
Natural gas (Mmcf)	38,794	47,409	86
As of December 31, 2006			
Crude oil (MBbls)	1,708	1,112	2
Natural gas (Mmcf)	37,333	44,499	81

The process of estimating crude oil and natural gas reserves is complex and involves decisions and assumptions in the evaluation of available geological, geophysical, engineering and economic data. Therefore, these estimates are imprecise.

Actual future production, natural gas and crude oil prices, revenues, taxes, development expenditures, operating expenses and quantities of recoverable natural gas and crude oil reserves most likely will vary from those estimated. Any significant variance could materially affect the estimated quantities and present value of reserves set forth in this annual report. In addition, we may adjust estimates of proved reserves to reflect production history, results of exploration and development, prevailing natural gas and crude oil prices and other factors, many of which are beyond our control.

You should not assume that the present value of future net revenues referred to in this annual statement is the current market value of our estimated natural gas and crude oil reserves. In accordance with SEC requirements, the estimated discounted future net cash flows from proved reserves are generally based on prices and costs as of the end of the year of the estimate, or alternatively, if prices subsequent to that date have increased, a price near the periodic filing date of the Company's financial statements. Because we use the full cost method to account for our natural gas and crude oil operations, we are susceptible to significant non-cash charges during times of volatile commodity prices because the full cost pool may be impaired when prices are low. This is known as a "ceiling limitation write-down." This charge does not impact cash flow from operating activities but does reduce our stockholders' equity and reported earnings. We have experienced ceiling limitation write-downs in the past and we cannot assure you that we will not experience additional ceiling limitation write-downs in the future. For more information regarding the full cost method of accounting, you should read the information under "Management's Discussion and Analysis of Financial Condition and Results of Operation - Critical Accounting Policies."

Actual future prices and costs may be materially higher or lower than the prices and costs as of the end of the year of the estimate. Any changes in consumption by natural gas purchasers or in governmental regulations or taxation will also affect actual future net cash flows. The timing of both the production and the expenses from the development and production of natural gas and crude oil properties will affect the timing of actual future net cash flows from proved reserves and their present value. In addition, the 10% discount factor, which is required by the SEC to be used in calculating discounted future net cash flows for reporting purposes, is not necessarily the most accurate discount factor. The effective interest rate at various times and the risks associated with us or the natural gas and crude oil industry in general will affect the accuracy of the 10% discount factor.

The estimates of our reserves are based upon various assumptions about future production levels, prices and costs that may not prove to be correct over time. In particular, estimates of natural gas and crude oil reserves, future net revenue from proved reserves and the PV-10 thereof for the natural gas and crude oil properties described in this report are based on the assumption that future natural gas and crude oil prices remain the same as natural gas and crude oil prices at December 31, 2006. The average sales prices as of such date used for purposes of such estimates were $56.42 per Bbl of crude oil and $5.83 per Mcf of natural gas. It is also assumed that we will make future capital expenditures of approximately $83.0 million in the aggregate, most of which is in the years 2007 through 2012, which are necessary to develop and realize the value of proved undeveloped reserves on our properties. Any significant variance in actual results from these assumptions could also materially affect the estimated quantity and value of reserves set forth herein.

We file reports of our estimated natural gas and crude oil reserves with the Department of Energy. The reserves reported to this agency are required to be reported on a gross operated basis and therefore are not comparable to the reserve data reported herein.

Crude Oil, Natural Gas Liquids, and Natural Gas Production and Sales Prices

The following table presents our net crude oil, net natural gas liquids and net natural gas production, the average sales price per Bbl of crude oil and natural gas liquids and per Mcf of natural gas produced and the average cost of production per Mcfe of production sold, for the three years ended December 31, 2006:

	2006	2005	2004
Crude oil production (Bbls)	200,436	194,366	220
Natural gas production (Mcf)	6,515,055	4,942,355	4,403
Natural gas liquids production (Bbls)	-	-	8
Total production (Mmcfe) (2)	7,718	6,109	5
Average sales price per Bbl of crude oil	$ 62.10	$ 53.27	$ 4
Average sales price per Mcf of natural gas (1)	$ 5.78	$ 7.48	$

Average sales price per Bbl of natural gas liquids	$ -	$ -	$ 2
Average sales price per Mcfe	$ 6.49	$ 7.75	$
Average cost of production per Mcfe produced (2)	$ 1.52	$ 1.82	$

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(1) Average sales prices are net of hedging activity.
(2) Natural gas and crude oil were combined by converting crude oil and natural gas liquids to a Mcf equivalent on the basis of 1 Bbl of crude oil and natural gas liquid equals 6 Mcf of natural gas. Production costs include direct operating costs, ad valorem taxes and gross production taxes.

Drilling Activities

The following table sets forth our gross and net working interests in exploratory and development wells drilled during the three years ended December 31, 2006:

	2006		2005	
	Gross(1)	Net(2)	Gross(1)	Net(2)
Exploratory(3)				
Productive(4)				
Crude oil	-		1.0	1.0
Natural gas	1.0	1.0	1.0	1.0
Dry holes(5)	1.0	1.0	-	-
Total	2.0	2.0	2.0	2.0
Development(6)				
Productive (4)				
Crude oil	2.0	1.2	4.0	4.0
Natural gas	1.0	1.0	5.0	5.0
Dry holes (5)	-	-	1.0	1.0
Total	3.0	2.2	10.0	10.0

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(1) A gross well is a well in which we own an interest.
(2) The number of net wells represents the total percentage of working interests held in all wells (e.g., total working interest of 50% is equivalent to 0.5 net well. A total working interest of 100% is equivalent to 1.0 net well).
(3) An exploratory well is a well drilled to find and produce natural gas or crude oil in an unproved area, to find a new reservoir in a field previously found to be producing natural gas or crude oil in another reservoir, or to extend a known reservoir.
(4) A productive well is an exploratory or a development well that is not a dry hole.
(5) A dry hole is an exploratory or development well found to be incapable of

producing either natural gas or crude oil in sufficient quantities to justify completion as a natural gas or crude oil well.

(6) A development well is a well drilled within the proved area of a natural gas or crude oil reservoir to the depth of stratigraphic horizon (rock layer or formation) noted to be productive for the purpose of extracting proved natural gas or crude oil reserves.

As of March 9, 2007, we had 3 wells in process of drilling and/or completing.

Office Facilities

Our executive and administrative offices are located at 500 North Loop 1604 East, Suite 100, San Antonio, Texas 78232, consisting of approximately 12,650 square feet leased through January 2009 at an aggregate base rate of $21,152 per month. We also have an office in Midland, Texas consisting of 570 square feet leased through February 2008 at an aggregate base rate of $439 per month.

Other Properties

We own 10 acres of land, an office building, workshop, warehouse and house in Sinton, Texas, 2.8 acres of land and an office building in Scurry County, Texas, 600 acres of land in Scurry County, Texas, 160 acres of land in Coke County, Texas and 11,537 acres of land in Pecos County, Texas. We also own 22 vehicles which are used in the field by employees. We own two workover rigs, which are used for servicing our wells.

Item 3. Legal Proceedings

From time to time, Abraxas is involved in litigation relating to claims arising out of its operations in the normal course of business. At December 31, 2006, Abraxas was not engaged in any legal proceedings that are expected, individually or in the aggregate, to have a material adverse effect on Abraxas.

Item 4. Submission of Matters to a Vote of Security Holders

No matter was submitted to a vote of our security holders during the fourth quarter of the fiscal year ended December 31, 2006.

PART II

Item5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information

Our common stock began trading on the American Stock Exchange on August 18, 2000, under the symbol "ABP." The following table sets forth certain information as to the high and low sales price quoted for our common stock on the American Stock Exchange.

	Period	High	Low
2005			
	First Quarter	$ 2.92	$ 1.92

	Second Quarter	3.38	2.15
	Third Quarter	8.99	2.71
	Fourth Quarter	9.25	5.15
2006			
	First Quarter	$ 7.25	$ 5.24
	Second Quarter	6.50	4.00
	Third Quarter	4.86	2.90
	Fourth Quarter	4.35	2.90
2007	First Quarter (Through March 9, 2007)	$ 3.42	$ 2.81

Holders

As of March 9, 2007, we had 42,769,284 shares of common stock outstanding and had approximately 1,206 stockholders of record.

Dividends

We have not paid any cash dividends on our common stock and it is not presently determinable when, if ever, we will pay cash dividends in the future. In addition, the indenture governing our notes and our revolving credit facility prohibit the payment of cash dividends and stock dividends on our common stock. You should read the discussion under "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources" for more information regarding the restrictions on our ability to pay dividends.

Performance Graph

Set forth below is a performance graph comparing yearly cumulative total stockholder return on the Abraxas common stock with (a) the monthly index of stocks included in the Standard and Poor's 500 Index and (b) the Energy Capital Solutions Index (the "ECS Index") of stocks of crude oil and natural gas exploration and production companies with a market capitalization of less than $800 million (the "Comparable Companies"). The Comparable Companies are: Adams Resources & Energy Inc., Callon Petroleum Company, Carrizo Oil & Gas Inc., Clayton Williams Energy Inc., Double Eagle Petroleum Company, Edge Petroleum Corporation, Contango Oil & Gas Company, CREDO Petroleum Corporation, Markwest Hydrocarbon Inc., NGAS Resources Inc., Parallel Petroleum Corporation and Arena Resources Inc.

All of these cumulative total returns are computed assuming the value of the investment in Abraxas common stock and each index as $100.00 on December 31, 2001, and the reinvestment of dividends at the frequency with which dividends were paid during the applicable years. The years compared are 2002, 2003, 2004, 2005 and 2006.

[GRAPHIC OMITTED][GRAPHIC OMITTED]

Quarterly

Small Cap Index		S&P 500		ABP	
12/31/2001	$100.00	12/31/2001	$100.00	12/31/2001	$100.00
3/29/2002	$109.30	3/29/2002	$99.94	3/29/2002	$100.76
6/28/2002	$98.30	6/28/2002	$86.22	6/28/2002	$56.82
9/27/2002	$86.17	9/27/2002	$72.07	9/27/2002	$56.82
12/31/2002	$98.07	12/31/2002	$76.63	12/31/2002	$42.42

3/31/2003	$98.41	3/31/2003	$73.88	3/31/2003	$51.52
6/30/2003	$140.06	6/30/2003	$84.88	6/30/2003	$81.82
9/30/2003	$148.41	9/30/2003	$86.75	9/30/2003	$68.18
12/31/2003	$201.65	12/31/2003	$96.85	12/31/2003	$93.18
3/31/2004	$227.72	3/31/2004	$98.10	3/31/2004	$200.76
6/30/2004	$224.40	6/30/2004	$99.37	6/30/2004	$125.76
9/30/2004	$220.12	9/30/2004	$97.08	9/30/2004	$161.36
12/31/2004	$251.01	12/31/2004	$105.56	12/31/2004	$175.76
3/31/2005	$315.58	3/31/2005	$102.83	3/31/2005	$215.15
6/30/2005	$324.15	6/30/2005	$103.77	6/30/2005	$209.09
9/30/2005	$492.48	9/30/2005	$107.03	9/30/2005	$600.76
12/30/2005	$469.62	12/30/2005	$108.73	12/30/2005	$400.00
3/31/2006	$509.42	3/31/2006	$112.78	3/31/2006	$444.70
6/30/2006	$534.02	6/30/2006	$110.64	6/30/2006	$327.27
9/29/2006	$478.98	9/29/2006	$116.36	9/29/2006	$231.82
12/29/2006	$602.29	12/29/2006	$123.54	12/29/2006	$234.09

	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05	Dec-06
ECS Index	100.00	98.07	201.65	251.01	469.62	602.29
S&P 500	100.00	76.63	96.85	105.56	108.73	123.54
ABP	100.00	42.42	93.18	175.76	400.00	234.09

Item 6. Selected Financial Data

The following selected financial data as of and for the years ended is derived from our Consolidated Financial Statements. The data should be read in conjunction with our Consolidated Financial Statements and Notes thereto, and other financial information included herein. See "Financial Statements" in Item 8.

	Year Ended December 31,			
	2006	2005	2004	
	(Dollars in thousands except per s			
Total revenue - continuing operations	$ 51,723	$ 48,625	$ 33,854	$
Net income (loss)	$ 1,246	$ 19,117 (1)	$ 12,360 (2)	$
Net income (loss) - discontinued operations	$ -	$ 12,846 (1)	$ 3,323	$
Net income (loss) - continuing operations	$ 1,246	$ 6,271	$ 9,037	$
Net income (loss) per common share - diluted	$ 0.03	$ 0.46	$ 0.32	$
Weighted average shares outstanding - diluted (in thousands)	43,862	41,164	38,895	
Total assets	$ 117,486	$ 121,866	$ 152,685	$
Long-term debt, excluding current maturities	$ 127,614	$ 129,527	$ 126,425	$
Total stockholders' equity (deficit)	$ (21,619)	$ (23,701)	$ (53,464)	$

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(1) Includes gain on the sale of foreign subsidiary of $17.3 million net of non-cash tax of $6.1 million.

(2) Includes gain on debt extinguishment of $12.6 million and a deferred tax benefit of $6.1 million.
(3) Includes gain on sale of foreign subsidiaries of $ 68.9 million in 2003.
(4) Includes ceiling limitation write-down of $116.0 million ($28.2 million related to continuing operations).
(5) For the year ended December 31, 2003, 711,928 shares were excluded from the calculation of diluted earnings per share since their inclusion would have been antidilutive.

Item 7. Management's Discussion And Analysis Of Financial Condition And Results Of Operations

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

The following is a discussion of our consolidated financial condition, results of continuing operations, liquidity and capital resources. This discussion should be read in conjunction with our Consolidated Financial Statements and the Notes thereto. See "Financial Statements" in Item 8.

General

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

While we have attained positive net income from continuing operations in three of the last five years, there can be no assurance that operating income and net earnings will be achieved in future periods. Our financial results depend upon many factors which significantly affect our results of operations including the following:

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

o the level and success of exploration and development activity.

Commodity Prices and Hedging Activities. The results of our operations are highly dependent upon the prices received for our natural gas and crude oil production. Substantially all of our sales of natural gas and crude oil are made in the spot market, or pursuant to contracts based on spot market prices, and not pursuant to long-term, fixed-price contracts. Accordingly, the prices received for our natural gas and crude oil production are dependent upon numerous factors beyond our control. Significant declines in prices for natural gas and crude oil could have a material adverse effect on our financial condition, results of operations and quantities of reserves recoverable on an economic basis. Recently, the prices of natural gas and crude oil have been volatile. During the first half of 2006, prices for natural gas and crude oil were sustained at record or near-record levels. Supply and geopolitical uncertainties resulted in significant price volatility during the remainder of 2006 with both natural gas and crude oil prices weakening. New York Mercantile Exchange (NYMEX) futures prices for West Texas Intermediate (WTI) crude oil averaged $66.18 per barrel for the year, with a low price of about $56.27 per barrel occurring in the fourth quarter of 2006. U.S. natural gas pricing declined during 2006. NYMEX Henry Hub futures prices averaged $6.98 per million

British thermal units (MMBtu) during 2006 as compared to $9.13 per MMBtu during 2005. The natural gas market continues to be driven by high natural gas storage inventories and mild early winter conditions for much of the country. NYMEX natural gas prices ended the year at about $6.30 per MMBtu. The outlook for the commodity markets in 2007 calls for continued volatility.

We seek to reduce our exposure to price volatility by hedging our production through price floors. In 2005 we incurred a hedging loss of $592,000. For the years ended December 31, 2004 and 2006 we recognized gains from hedging activities of approximately $118,000 and $646,000 respectively.

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

Time Period	Notional Quantities	Price
April 2007	10,000 MMbtu of production per day	Floor of $ 4.50
May 2007	10,000 MMbtu of production per day	Floor of $ 5.00
June 2007	10,000 MMbtu of production per day	Floor of $ 5.00
July 2007	10,000 MMbtu of production per day	Floor of $ 4.25
August 2007	10,000 MMbtu of production per day	Floor of $ 5.00
September 2007	10,000 MMbtu of production per day	Floor of $ 5.50

At December 31, 2006 the aggregate fair market value of our hedges was approximately $157,286.

Production Volumes. Because our proved reserves will decline as natural gas and crude oil are produced, unless we acquire additional properties containing proved reserves or conduct successful 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, exploration and development projects.

We had capital expenditures for 2006 of $26.3 million and have a capital budget for 2007 ranging from $27 to $44 million in 2007, the exact amount of which will depend on our success rate, production levels and commodity prices. During 2006, our production volumes increased by 26% over 2005.

Availability of Capital. As described more fully under "Liquidity and Capital Resources" below, our sources of capital going forward will primarily be cash from operating activities, funding under our revolving credit facility, cash on hand, and if an appropriate opportunity presents itself, proceeds from the sale of properties. We currently have approximately $12.7 million of availability under our revolving credit facility. We may also seek equity capital in order to fund our planned drilling expenditures.

Exploration and Development Activity. We believe that our high quality asset base, high degree of operational control and large inventory of drilling projects position us for future growth. Our properties are concentrated in locations that facilitate substantial economies of scale in drilling and production operations and more efficient reservoir management practices. We operate 94% of the properties accounting for approximately 93% of our PV-10, giving us substantial control over the timing and incurrence of operating and capital expenditures. In addition, we have 51 proved undeveloped projects and have identified over 500 drilling and recompletion opportunities on our existing acreage, the successful development of which we believe could significantly increase our daily production and proved reserves.

Our future natural gas and crude oil production, and therefore our success, is highly dependent upon our ability to find, acquire and develop additional reserves that are profitable to produce. The rate of production from our natural gas and crude oil properties and our proved reserves will decline as our reserves are produced unless we acquire additional properties containing proved reserves, conduct successful development and exploration activities or, through engineering studies, identify additional behind-pipe zones or secondary recovery reserves. We cannot assure you that our exploration and development activities will result in increases in our proved reserves. For example, in 2006, while we have had some success in pursuing these activities, we were not able to fully replace the production volumes lost from natural field declines and property sales. If our proved reserves continue to decline in the future, our production will also decline and, consequently, our cash flow from operations and the amount that we are able to borrow under our revolving credit facility will also

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decline. In addition, approximately 52% of our total estimated proved reserves at December 31, 2006 were undeveloped. By their nature, estimates of undeveloped reserves are less certain. Recovery of such reserves will require significant capital expenditures and successful drilling operations. For a more complete discussion of these risks please see "Risk Factors--We may be unable to acquire or develop additional reserves, in which case our results of operations and financial condition would be adversely affected."

Borrowings and Interest. We currently have indebtedness of approximately $127.3 million and availability of $12.7 million under the revolving credit facility. Cash interest expense was $16.6 million during 2006 and based on current interest rates and our outstanding indebtedness at March 9, 2007, would be approximately $16.3 million for 2007. This increase in cash interest expense resulted in a larger percentage of our production and cash flow from operations being used to meet our debt service requirements. As a result, we will need to increase our cash flow from operations in order to fund the development of our numerous drilling opportunities which, in turn, will be dependent upon the level of our production volumes and commodity prices.

Results of Operations

Selected Operating Data. The following table sets forth certain of our operating data for the periods presented. All data has been restated to reflect continuing operations.

	Years Ended December 31 (dollars in thousands, except per unit d		
	2006	2005	
Operating revenue(1):			
Crude oil sales............................	$ 12,446	$ 10,354	$
NGLs sales	-	-	
Natural gas sales..........................	37,648	36,960	
Rig and other..............................	1,629	1,311	
Total operating revenues	$ 51,723	$ 48,625	$
Operating income	$ 19,575	$ 22,104	$
Crude oil production (MBbls)...............	200.4	194.4	
NGLs production (MBbls)....................	-	-	
Natural gas production (MMcf)..............	6,515.0	4,942.4	
Average crude oil sales price (per Bbl)	$ 62.10	$ 53.27	$
Average NGLs sales price (per Bbl)	$ -	$ -	$
Average natural gas sales price (per Mcf)	$ 5.78	$ 7.48	$

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(1) Revenue and average sales prices are net of hedging activities.

Comparison of Year Ended December 31, 2006 to Year Ended December 31, 2005

Operating Revenue. During the year ended December 31, 2006, operating revenue from natural gas and crude oil sales increased by $2.8 million from $47.3 million in 2005 to $50.1 million in 2006. The increase in revenue was primarily due to increased production volumes in 2006 as compared to 2005 offset by lower natural gas prices realized in 2006 as compared to 2005. Higher production volumes contributed $12.1 million to natural gas and crude oil revenue, and increased crude oil realized prices contributed $1.8 million. Lower natural gas prices had a negative impact of $11.1 million on natural gas and crude oil revenue during 2006.

Crude oil sales volumes increased from 194.4 MBbls in 2005 to 200.4 MBbls during 2006. The increase in crude oil production was primarily due to production from wells in Wyoming and south Texas that were brought onto production during 2006. Natural gas sales volumes increased from 4.9 Bcf in 2005 to 6.5 Bcf in 2006. This increase was primarily due to production from a west Texas well drilled and brought onto production in August 2005. This well produced 2.2 Bcf in 2006 as compared to 0.6 Bcf in 2005. The increase in production was partially offset by natural field declines and the sale of properties in Live Oak County, Texas effective August 1, 2006. These properties produced 286.8 MMcf in 2005 compared to 182.3 MMcf in 2006 through the date of sale.

Average sales prices in 2006 net of hedging costs were:

- $62.10 per Bbl of crude oil, and
- $ 5.78 per Mcf of natural gas.

Average sales prices in 2005 net of hedging costs were:

- $53.27 per Bbl of crude oil, and
- $ 7.48 per Mcf of natural gas.

Lease Operating Expense and Production Taxes. Lease operating expense, or LOE, increased from $11.1 million in 2005 to $11.8 million in 2006. The increase in LOE was primarily due to a general increase in the cost of field services. Lower production taxes, due to the lower realized price for natural gas, were offset by increased advalorem taxes related to new wells. Our LOE on a per Mcfe basis for the year ended December 31, 2006 was $1.52 per Mcfe compared to $1.82 per Mcfe in 2005. The decrease on a per Mcfe basis was primarily due to increased production volumes in 2006 as compared to 2005.

G&A Expense. General and administrative, or G&A expense, excluding stock based compensation decreased from $5.5 million in 2005 to $4.2 million in 2006. The decrease in G&A expense in 2006 was primarily due to higher performance bonuses in 2005 as compared to 2006. Performance bonuses amounted to $162,000 in 2006, as compared to $960,000 in 2005. Our G&A expense on a per Mcfe basis decreased from $0.90 in 2005 to $0.54 in 2006. The decrease in the per Mcfe cost was due to decreased G&A expense in 2006 as compared to 2005 as well as increased production volumes in 2006 as compared to 2005.

Stock-based Compensation. In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment." SFAS No. 123R is a revision of SFAS No. 123, "Accounting for Stock Based Compensation", and supersedes APB 25. Among other items, SFAS 123R eliminates the use of APB 25 and the intrinsic value method of accounting, and requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements. Pro forma disclosure is no longer an alternative under the new standard. In December 2005, we elected early adoption of SFAS 123R .

SFAS 123R permits companies to adopt its requirements using either a "modified prospective" method or a "modified retrospective" method. We elected to use the "modified retrospective" method. Under the "modified retrospective" method, compensation cost is recognized in the financial statements beginning with the effective date, based on the requirements of SFAS 123R for all share-based payments granted after that date, and based on the requirements of SFAS 123 for all unvested awards granted prior to the effective date of SFAS 123R. The "modified retrospective" method, also permits entities to restate financial statements of previous periods based on proforma disclosures made in accordance with SFAS 123, accordingly we have restated prior year financial statements to reflect this method.

As a result of the retrospective adoption of SFAS 123R, the expenses previously recognized under the rules of variable accounting were reversed and a compensation expense measured according to SFAS 123R was recorded. As a result, we recognized stock-based compensation of $998,000 during 2006 as a result of the adoption of this accounting change compared to $247,000 in 2005, as restated. The increase in stock-based compensation in 2006 as compared to 2005 was due to new options granted during the latter part of 2005 and the first half of 2006 and the increase in the calculated fair value of these grants due to higher option prices as a result of the increase in the price of our Common Stock over previous option grants. Also contributing to the increase was director options grants that vest upon issuance resulting in all of the fair value of the options being recognized as stock-based compensation in the current period.

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

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(10)

*

Mary
E. Chowning

37,500
(11)

*

Thomas
R. Curran, Jr.

—
(12)

*

William C. Mills III	— (13)	*
All current executive officers and directors as a Group (9 persons)	2,136,390 (14)	5.73 %

Series A Preferred Stock

Pyxis Innovations Inc.	5,000,000	100 %

* Represents less than 1% of the issued and outstanding shares.

(1) Unless otherwise indicated, the address for each person is our address at 135 Beaver Street, Waltham, MA 02452.

(2) Based solely on a Schedule 13D/A filed on February 3, 2010 with the SEC by Pyxis Innovations Inc. and affiliated entities. Consists of (i) 6,884,056 shares of common stock, (ii) 28,160,200 shares of common stock issuable upon conversion of 5,000,000 shares of our Series A Preferred Stock and (iii) 1,588,479 shares of common stock issuable upon conversion of outstanding convertible notes.

(3) Based solely on a Schedule 13G/A filed on January 17, 2007 with the SEC by Mr. Garofalo, which reported ownership as of December 31, 2006. Consists of (i) 2,368,500 of shares owned directly by Mr. Garofalo; (ii) 50,000 shares owned by Mr. Garofalo's spouse; and (iii) 814,967 shares owned by First Global Technology Corp. ("First Global"). Mr. Garofalo is the controlling stockholder of First Global. Mr. Garofalo has sole voting and investment power with respect to the shares owned directly by him and shared voting and investment power with respect to the shares owned by his spouse and First Global.

(4) Based solely on a Schedule 13G/A Amendment filed on January 16, 2008 with the SEC by Mr. Peterson, which reported ownership as of December 31, 2007.

(5) Includes 300,000 shares of common stock issuable upon exercise of options held by Mr. Bender within 60 days following April 13, 2010.

(6) Includes 898,723 shares of common stock held by a limited partnership of which Dr. Kornman is a general partner. As such, Dr. Kornman may be deemed the beneficial owner of these shares. Dr. Kornman disclaims beneficial ownership of these shares. Includes 475,000 shares of common stock issuable upon exercise of options held by Dr. Kornman within 60 days following April 13, 2010.

(7) Includes 14,000 shares of common stock issuable upon exercise of options held by Mr. Lurier within 60 days following April 13, 2010.

(8) Although appointed as a Series A director by Pyxis Innovations Inc., we have been advised that Mr. Weaver does not, directly or indirectly, have voting or investment power over the shares of stock held by Pyxis.

(9) Although appointed as a Series A director by Pyxis Innovations Inc., we have been advised that Dr. Armstrong does not, directly or indirectly, have voting or investment power over the shares of stock held by Pyxis.

(10) Although appointed as a Series A director by Pyxis Innovations Inc., we have been advised that Dr. Calvert does not, directly or indirectly, have voting or investment power over the shares of stock held by Pyxis.

(11) Includes 7,500 shares of common stock issuable upon exercise of options held by Ms. Chowning within 60 days following April 13, 2010. Includes 10,000 shares of restricted common stock granted to Ms. Chowning on March 17, 2010, which vests in four equal annual installments beginning on March 17, 2011.

(12) Although appointed as a Series A director by Pyxis Innovations Inc., we have been advised that Mr. Curran does not, directly or indirectly, have voting or investment power over the shares of stock held by Pyxis.

(13) Mr. Mills was elected to our Board of Directors on April 29, 2010. Upon his election, Mr. Mills was granted an option to purchase 15,000 shares of our common stock, which option vests in four equal annual installments on each of the first four anniversaries of the date of grant.

(14) See footnotes 5 through 13 above.

MANAGEMENT AND CORPORATE GOVERNANCE

The Board of Directors and Management

We are managed under the direction of our Board of Directors. Our Board of Directors currently consists of seven directors. Pursuant to our charter, the holders of shares of our Series A Preferred Stock are entitled to elect up to four directors to our Board of Directors (the "Series A Directors"), who are not apportioned among classes. Each of the Series A Directors is nominated and elected by Pyxis Innovations Inc., as the sole holder of shares of our Series A Preferred Stock. James M. Weaver, Glenn S. Armstrong, George D. Calvert, and Thomas R. Curran are our current Series A Directors. Our Board of Directors currently includes three directors who are not Series A Directors and who are classified into three classes as follows: (1) William C. Mills III, serves as a Class I director with a term ending at this annual meeting, (2) Lewis H. Bender serves as a Class II director with a term ending at the 2011 annual meeting, and (3) Mary E. Chowning serves as a Class III director with a term ending at the 2012 annual meeting.

On April 29, 2010, immediately following the resignation of Kenneth S. Kornman, DDS, Ph.D. from the Board, our Board of Directors, upon the recommendation of the Nominating Committee, elected William C. Mills III as a Class I director to fill the vacancy created by Dr. Kornman's resignation. Mr. Mills was also appointed by the Board to our Audit Committee and as the Chair of our Compensation Committee. Dr. Kornman continues to serve as our President and Chief Scientific Officer. On April 29, 2010, our Board of Directors, upon the recommendation of the Nominating Committee, also voted to nominate Mr. Mills for election at the annual meeting for a term of three years to serve until the 2013 annual meeting of stockholders, and until his successor has been elected and qualified.

Set forth below are the names of our director nominee as well as our directors whose terms do not expire this year and our executive officers, their ages, their position in the company, their principal occupations or employment for at least the past five years, the length of their tenure as directors and, for our directors, the names of other public companies in which they hold or heave held directorships during the past five years.

Name	Age	Position with the Company
Lewis H. Bender	51	Director, Chief Executive Officer
Kenneth S. Kornman, DDS, Ph.D.	62	President, Chief Scientific Officer
Eliot M. Lurier	52	Chief Financial Officer & Treasurer
James M. Weaver	46	Director and Chairman of the Board
Glenn S. Armstrong, Ph.D.(2)(3)	59	Director
George D. Calvert, Ph.D.(2)	46	Director
Mary E. Chowning(1)(2)	48	Director
Thomas R. Curran Jr.(1)(3)	51	Director
William C Mills III(1)(3)	54	Director

(1) Member of our Audit Committee
(2) Member of our Nominating Committee
(3) Member of our Compensation Committee

LEWIS H. BENDER has been our Chief Executive Officer since January 2008, and became a Director in July 2008. Prior to joining us and since 1993, he worked in various capacities at Emisphere Technologies, Inc., a biopharmaceutical company that develops oral forms of injectable drugs. Those positions included Chief Technology Officer from May 2007 to January 2008, President and Interim Chief Executive Officer from January 2007 to May 2007, Member of the Office of the President from 2002 to January 2008, Senior Vice President of Business Development from 1997 to 2007, Vice President of Business Development from 1995 to 1997 and Director of Business Development from 1993 to 1995. Prior to joining Emisphere Technologies, Inc., he worked as a Production Planning Specialist at F. Hoffmann La-Roche AG, a Product Manager at Métaux Précieux SA Metalor and in various managerial capacities at Handy and Harman. Mr. Bender earned an MBA from the University of Pennsylvania's Wharton School of Business, an MA in International Studies from the University of Pennsylvania's School of Arts and Sciences and an MS and a BS in Chemical Engineering from Massachusetts Institute of Technology. Our board of directors has concluded that Mr. Bender should serve as a director as of the date of this proxy statement because of his prior executive management experience and his knowledge of business development within the biotechnology industry. Mr. Bender has not served on any other public company boards in the past 5 years.

KENNETH S. KORNMAN, DDS, Ph.D. is our co-founder, President and Chief Scientific Officer. He was a member of our Board of Directors from August 2006 through April 2010. Prior to founding the Company in 1986, Dr. Kornman was a Department Chairman and Professor at The University of Texas Health Center at San Antonio. He has also been a consultant and scientific researcher for many major oral care and pharmaceutical companies. Dr. Kornman currently holds an academic appointment at Harvard University. He holds multiple patents in the pharmaceutical area, has published three books and more than 100 scientific papers and has lectured and consulted worldwide on the transfer of technology to clinical practice. Dr. Kornman also holds an MS (Periodontics) and Ph.D. (Microbiology-Immunology) from the University of Michigan.

ELIOT M. LURIER has been our Chief Financial Officer since April 2008. He became Treasurer in July 2008. Prior to joining the Company and since April 2005, Mr. Lurier was Vice President, Finance and Administration and Chief Financial Officer of Nucryst Pharmaceuticals, where he assisted in its initial public offering and was responsible for the company’s reporting to the Securities and Exchange Commission and the implementation of Sarbanes-Oxley requirements. From April 2004 to March 2005, Mr. Lurier served as Chief Financial Officer and Chief Operating Officer for Bridge Pharmaceuticals, Inc., where he established financial policies for managing business operations. From 1983 to 2004, Mr. Lurier held a number of senior-level financial positions, including Chief Financial Officer of Admetric Biochem, Inc., and Chief Financial Officer, Treasurer and Vice President of Finance of Ascent Pediatrics, Inc. From 1981 to 1983, Mr. Lurier was an auditor at Coopers and Lybrand in Boston, MA. He earned a B.S. in Accounting from Syracuse University in 1980 and is a Certified Public Accounting in Massachusetts.

JAMES M. WEAVER joined the Board of Directors in July 2007 and was appointed Chairman of the Board in September 2007. He is Vice President of Alticor Corporate Enterprises, a member of the Alticor Inc. family of companies, which is engaged in the principal business of offering products, business opportunities, and manufacturing and logistics services in more than 80 countries and territories worldwide. In this role, Mr. Weaver is responsible for managing the current portfolio of Alticor’s companies and directs its acquisition and growth. Prior to joining Alticor, Mr. Weaver worked for X-Rite Inc. where he held various leadership positions, including Senior Vice President and General Manager, Vice President of marketing and software development, Vice President of marketing and product development, as well as lead executive on several acquisitions. Mr. Weaver also founded and held the position of President and Chief Executive Officer of Bold Furniture Inc, and has held various leadership positions at Steelcase Inc. and Bissell Inc. Mr. Weaver received a Bachelor’s degree in general studies from the University of Michigan in Ann Arbor and serves on several non-profit and private company boards. Our board of directors has concluded that Mr. Weaver should serve as a director as of the date of this proxy statement because of his prior senior management experience and judgment and his extensive sales and marketing experience in the consumer product industry. Mr. Weaver has not served on any other public company boards in the past 5 years.

GLENN S. ARMSTRONG, Ph.D. joined the Board of Directors in July 2008. Dr. Armstrong is Vice President of Corporate/Business Innovations for Alticor Inc. and leads Alticor’s Growth Through Innovation initiative. He joined Alticor in July 2007 from the Wm. Wrigley Jr. Company, where he was senior director and lead scientist of the company’s New Ventures Group & Mergers and Acquisitions. Dr. Armstrong is the former founder and president of Armstrong Sargent Group, Inc., a marketing, research and development, and technology assessment consulting firm. He also held marketing, innovation and product development, and science research positions with Whirlpool Corp., Quaker Oats Company, and General Mills, Inc. Dr. Armstrong earned a Bachelor of Science degree in botany from Eastern Illinois University in Charleston, Ill. He received a Master of Science degree in food science, and a Ph.D. in food science from Purdue University in West Lafayette, Ind. He also studied with a research team as a research chemist at Massachusetts Institute of Technology. Our board of directors has concluded that Dr. Armstrong should serve as a director as of the date of this proxy statement because of his prior executive marketing, technology and research development experience and his knowledge of business development within various technical industries. Dr. Armstrong has not served on any other public company boards in the past 5 years.

GEORGE D. CALVERT, Ph.D. joined the Board of Directors as a Series A Director in connection with our transactions with Pyxis Innovations Inc. in March 2003. In March 2009, Dr. Calvert, was appointed Vice President, Supply Chain and Research & Development for Amway. In his current role, Dr. Calvert is responsible for global manufacturing, sourcing, logistics, facilities and all technical functions for Amway. Previously, he held the positions of Vice President, Research & Development/Quality Assurance, Director of Quality Assurance/Analytical Services and Senior Manager Home Tech Research & Development at Amway. Dr. Calvert earned a Ph.D. in Analytical Chemistry from the University of South Carolina and a Bachelor of Science degree in Chemistry from the College of William and Mary. Our board of directors has concluded that Dr. Calvert should serve as a director as of the date of this proxy statement because of his prior management experience and his knowledge of manufacturing and research and development within various global industries. Dr. Calvert has not served on any other public company boards in the past 5 years.

MARY E. CHOWNING joined the Board of Directors in July 2008. Ms. Chowning has served as President of the McCue Corporation since January 2010. From May 2008 to December 2009 Ms. Chowning was the managing partner of Colonnade Consulting LLC. Ms. Chowning served as Vice President, Chief Financial Officer and Secretary of X-Rite Inc., from July 2003 to July 2006. Ms. Chowning served as an Executive Vice President, Chief Financial Officer and Secretary of X-Rite Inc., from July 2006 to March 2008 and also served as its Principal Accounting Officer from July 2003 to March 2008. Ms. Chowning retired from X-Rite Inc. in April 2008. Prior to X-Rite, she co-founded the Wind River group of companies and served as its Managing Member, as well as its Chief Financial Officer for four years. Ms. Chowning began her career with Arthur Andersen LLP and spent 14 years in Public Accounting where she served in various positions of increasing responsibility with public and private clients in manufacturing, consumer products, technology and various service industries. She was made a Partner in the firm in 1996. Ms. Chowning is a graduate of the University of California where she holds a Bachelor of Arts in Economics. She is a Certified Public Accountant in California and a member of the American Institute of Certified Public Accountants. Our board of directors has concluded that Ms. Chowning should serve as a director as of the date of this proxy statement because of her prior executive management experience, judgment, public company experience and financial expertise. Ms.Chowning has not served on any other public company boards in the past 5 years.

THOMAS R. CURRAN, JR. joined the Board of Directors as a Series A Director in connection with our transactions with Pyxis Innovations Inc. in March 2003. In addition to his role as director, he served as our Interim Chief Executive Officer from July 2007 through January 2008. Mr. Curran is employed as the Director of Portfolio Management for Alticor Corporate Enterprises and Vice President of Business Development for Metagenics Inc. Mr. Curran served as Associate General Counsel/Corporate Development and Commercial Transactions of Alticor Inc., a company engaged in the principal business, through its affiliates, of offering products, business opportunities, and manufacturing and logistics services in more than 80 countries and territories worldwide. Concurrently, Mr. Curran also held the position of Chief Legal Officer for Access Business Group LLC, a manufacturing and distribution company and wholly owned subsidiary of Alticor Inc. Prior to joining Alticor, Mr. Curran was a partner in the law firm of Howard & Howard in Bloomfield Hills, Michigan. From 1982 to 1991, Mr. Curran worked for the Polaroid Corporation in various domestic and international financial and managerial positions. Mr. Curran holds a Bachelor of Arts from Providence College, a Master of International Management from the Thunderbird School of Global Management and a Juris Doctorate from Suffolk University Law School. Our board of directors has concluded that Mr. Curran should serve as a director as of the date of this proxy statement because of his judgment, knowledge of the company’s products and technology and extensive legal experience. Mr. Curran has not served on any other public company boards in the past 5 years.

WILLIAM C. MILLS III joined the Board of Directors in April 2010. He is currently an independent venture capitalist with over 29 years of experience in venture capital. From 2004 until 2009, Mr. Mills was a managing member of a management company conceived by EGS Healthcare Capital Partners to manage EGS Private Healthcare Partnership III. Earlier, Mr. Mills was a Partner in the Boston office of Advent International, a private equity and venture capital firm, for five years. At Advent, he was co-responsible for healthcare venture capital investments and focused on investments in the medical technology and biopharmaceutical sectors. Before joining Advent, Mr. Mills spent more than 11 years with the Venture Capital Fund of New England where he was a General Partner. Prior to that, he spent seven years at PaineWebber Ventures/Ampersand Ventures as Managing General Partner. Currently, he is a member of the Board of Managers of Ascension Health Ventures. Mr. Mills received his A.B. in Chemistry, cum laude, from Princeton University, his S.M. in Chemistry from the Massachusetts Institute of Technology and his M.S. in Management from MIT’s Sloan School of Management. Our board of directors has concluded that Mr. Mills has significant experience serving on the boards of growing companies in the medical technology and biotechnology fields. This experience, coupled with his scientific and technical expertise, provides valuable knowledge regarding the Company’s intellectual property, regulatory, and compliance activities. Mr. Mills currently serves on the Board of Directors of Stereotaxis, Inc., a publicly traded medical device company. Mr. Mills has not served on any other public company boards in the past 5 years.

Director Independence

Our Board of Directors has determined that the following members qualify as independent directors under the definition promulgated by the NYSE Amex: Glenn S. Armstrong, Ph.D., George D. Calvert, Ph.D., Mary E. Chowning, Thomas R. Curran, Jr., William C. Mills III and James M. Weaver.

Committees of the Board of Directors and Meetings

Committees. Our Board of Directors has established three standing committees, Audit, Compensation and Nominating, each as described below.

Meeting Attendance. During the fiscal year ended December 31, 2009, the Board of Directors met eight times. Each of our Directors attended at least 75% of the aggregate of the meetings of the Board of Directors and committees of which they are a member. The Board of Directors has adopted a policy under which each member is encouraged to make every reasonable effort to attend each annual meeting of our stockholders. Four of the directors attended our 2009 annual meeting of stockholders.

Audit Committee and Financial Experts

Prior to April 29, 2010, the members of our Audit Committee were Mary E. Chowning (Chair), James M. Weaver, and Thomas R. Curran, Jr. On April 29, 2010, William C. Mills III was appointed to the Audit Committee to replace Mr. Weaver. Our Audit Committee met four times during the fiscal year ended December 31, 2009. Our Audit Committee is responsible for retaining and overseeing our independent accountants, approving the services performed by them and reviewing our annual financial statements, accounting policies and our system of internal controls. All members of the Audit Committee satisfy the current independence standards promulgated by the Securities and Exchange Commission and the NYSE Amex, as such standards apply specifically to members of audit committees. The Board of Directors has determined that Ms. Chowning is an “audit committee financial expert” as the Securities and Exchange Commission has defined that term in Item 407 of Regulation S-K. A copy of the Audit Committee’s written charter is publicly available on our website at www.ilgenetics.com.

Compensation Committee

Prior to April 29, 2010, the members of our Compensation Committee were George D. Calvert (Chair), Glenn S. Armstrong, Ph.D., and Thomas R. Curran, Jr. On April 29, 2010, William C. Mills III was appointed as Chair of the Compensation Committee to replace Mr. Calvert. Our Compensation Committee met three times during the fiscal year ended December 31, 2009. Our Compensation Committee reviews our compensation philosophy and programs, exercises authority with respect to the payment of salaries and incentive compensation to our directors and officers and makes recommendations to the Board of Directors regarding stock option grants and stock awards under our stock plans. The Compensation Committee is responsible for the determination of the compensation of our Chief Executive Officer, and conducts its decision making process with respect to that issue without the Chief Executive Officer present. All members of the Compensation Committee qualify as independent under the definitions promulgated by the NYSE Amex. A copy of the Compensation Committee’s written charter is publicly available on our website at www.ilgenetics.com.

Nominating Committee

Our Nominating Committee currently consists of Glenn S. Armstrong, Ph.D. (Chair), George D. Calvert, and Mary E. Chowning. Our Nominating Committee met one time during the fiscal year ended December 31, 2009. All members of the Nominating Committee qualify as independent under the definition promulgated by the NYSE Amex. This committee’s role is to make recommendations to the Board of Directors as to the size and composition of the Board of Directors and to make recommendations as to the particular nominees. The Nominating Committee may consider candidates recommended by stockholders, as well as from other sources, such as other directors, or officers, third party search firms or other appropriate sources. For all potential candidates, the Nominating Committee may consider all factors it deems relevant, such as a candidate’s personal integrity and sound judgment, business and professional skills and experience, independence, knowledge of the industry in which we operate, possible conflicts of interest, the extent to which the candidate would fill a present need on the Board of Directors, and concern for the long-term interests of the stockholders. The Nominating Committee also considers issues of diversity among its members in identifying and considering nominees and strives, if appropriate, to achieve a diverse balance of backgrounds, perspectives and experience. In general, persons recommended by stockholders will be considered on the same basis as candidates from other sources. If a stockholder wishes to nominate a candidate to be considered for election as a director at the 2011 Annual Meeting of Stockholders using the procedures set forth in the Company’s By-laws, it must follow the procedures described in “Stockholder Proposals and Nominations For Director” of this proxy statement. If a stockholder wishes simply to propose a candidate for consideration as a nominee by the Nominating Committee, it should submit any pertinent information regarding the candidate to the Chairman of the Nominating Committee by mail at Secretary, Interleukin Genetics, Inc., 135 Beaver Street, Waltham, Massachusetts 02452. A copy of the Nominating Committee’s written charter is publicly available on our website at www.ilgenetics.com.

Board Leadership Structure and Role in Risk Oversight

Our Board of Directors currently consists of seven directors, each of whom, other than Mr. Bender, is independent under NYSE Amex's independence standards. Mr. Bender has served as our CEO since January 2008 and as a member of our Board since July 2008. The Chairman of our Board of Directors is currently Mr. Weaver. The Board has determined that separating the positions of Chief Executive Officer and Chairman of the Board, and having an independent director serve as Chairman of the Board, is in the best interest of shareholders at this time in recognition of the differences between the two roles. Under this structure, the Chief Executive Officer is responsible for setting the strategic direction for the company and for providing the day-to-day leadership over our operations, while the Chairman of the Board provides guidance to the Chief Executive Officer, sets the agenda for Board meetings and presides over meetings of the full Board. In addition, the Chairman approves Board meeting agendas and schedules and generally approves information sent to the Board. This structure ensures a greater role for the independent directors in the oversight of the company and active participation of the independent directors in setting agendas and establishing priorities and procedures for the work of the Board. In addition, our independent directors meet in executive sessions after every scheduled Board meeting.

Generally, management is responsible for managing the risks that we face. The board of directors is responsible for overseeing management's approach to risk management that is designed to support the achievement of organizational objectives, including strategic objectives, to improve long-term organizational performance and enhance stockholder value. The involvement of the full Board of Directors in reviewing our strategic objectives and plans is a key part of the Board's assessment of management's approach and tolerance to risk. A fundamental part of risk management is not only understanding the risks a company faces and what steps management is taking to manage those risks, but also understanding what level of risk is appropriate for us. In setting our business strategy, our Board of Directors assesses the various risks being mitigated by management and determines what constitutes an appropriate level of risk for us. While the Board of Directors has ultimate oversight responsibility for overseeing management's risk management process, various committees of the Board of Directors assist it in fulfilling that responsibility. The Audit Committee assists the Board in its oversight of risk management in the areas of financial reporting, internal controls and compliance with certain legal and regulatory requirements and the Compensation Committee assists the board in its oversight of the evaluation and management of risks related to our compensation policies and practices.

Shareholder Communications to the Board

Generally, shareholders who have questions or concerns regarding Interleukin should contact Investor Relations at (781) 398-0700. However, any shareholders who wish to address questions regarding our business directly with the Board of Directors, or any individual director, should direct his or her questions in writing to the Chairman of the Board at Interleukin Genetics, Inc., 135 Beaver Street, Waltham, Massachusetts 02452. Communications will be distributed to the Board, or to any individual director or directors as appropriate, depending on the facts and circumstances outlined in the communications. Items that are unrelated to the duties and responsibilities of the Board may be excluded, such as:

- junk mail and mass mailings;
- resumes and other forms of job inquiries;
- surveys; and
- solicitations or advertisements.

In addition, any material that is unduly hostile, threatening, or illegal in nature may be excluded, provided that any communication that is filtered out will be made available to any outside director upon request.

Corporate Opportunity Agreement

We have agreed to certain terms for allocating opportunities as permitted under Section 122(17) of the Delaware General Corporation Law. This agreement, as set forth in the Series A Preferred Stock Purchase Agreement dated March 5, 2003, regulates and defines the conduct of certain of our affairs as they may involve Pyxis Innovations Inc. as our majority stockholder and its affiliates, and the powers, rights, duties and liabilities of us and our officers and directors in connection with corporate opportunities.

Except under certain circumstances, Pyxis and its affiliates have the right to engage in the same or similar activities or lines of business or have an interest in the same classes or categories of corporate opportunities as we do. If Pyxis, or one of our directors appointed by Pyxis and its affiliates acquire knowledge of a potential transaction or matter that may be a corporate opportunity for both Pyxis and its affiliates and us, to the fullest extent permitted by law, Pyxis and its affiliates will not have a duty to inform us about the corporate opportunity or be liable to us or to you for breach of any fiduciary duty as a stockholder of ours for not informing us of the corporate opportunity, keeping it for its own account, or referring it to another person.

Additionally, except under limited circumstances, if an officer or employee of Pyxis who is also one of our directors is offered a corporate opportunity, such opportunity shall not belong to us. In addition, we agreed that such director will have satisfied his duties to us and not be liable to us or to you in connection with such opportunity.

The terms of this agreement will terminate on the date that no person who is a director, officer or employee of ours is also a director, officer, or employee of Pyxis.

EXECUTIVE COMPENSATION

Summary Compensation Table

The following table sets forth the total compensation awarded or paid to, accrued or earned during the fiscal years ended December 31, 2009 and 2008 by our Chief Executive Officer and our next two most highly compensated executive officers who were employed by us as of December 31, 2009. We refer to these individuals as our "Named Executive Officers."

Name and Principal Position	Fiscal Year	Salary ($)	Bonus ($)(4)	Stock Awards ($)(1)(5)	Option Awards ($)(1)(5)	Non-Equity Incentive Plan Compensation ($)	Change in Pension Value and Nonqualified Deferred Compensation Earnings ($)	All Other Compensation ($)(6)	Total ($)
Lewis H. Bender	2009	$ 340,000	$ —	$ —	$ —	$ —	$ —	$ 6,300	$ 346,300
Chief Executive Officer(2)	2008	$ 319,077	$ 137,850	$ —	$ 392,312	$ —	$ —	$ 43,732	$ 892,971
Kenneth S. Kornman	2009	$ 354,923	$ —	$ 3,500	$ —	$ —	$ —	$ 4,548	$ 362,971
President and Chief Scientific Officer	2008	$ 338,692	$ —	$ 18,625	$ 52,553	$ —	$ —	$ 9,643	$ 419,513
Eliot M. Lurier	2009	$ 222,709	$ —	$ —	$ 6,109	$ —	$ —	$ 1,500	$ 230,318
Chief Financial Officer(3)	2008	$ 144,389	$ 58,695	$ —	$ 44,290	$ —	$ —	$ —	$ 247,374

(1) See Note 12 to our Financial Statements reported in our Annual Report on Form 10-K for our fiscal year ended December 31, 2009 for details as to the assumptions used to determine the fair value of the stock awards and option grants.

(2) Mr. Bender joined the Company on January 22, 2008 as Chief Executive Officer.

(3) Mr. Lurier joined the Company on April 30, 2008 as Chief Financial Officer.

(4) The 2008 bonus amount for Mr. Bender consists of: (i) a signing bonus of $35,000 when he joined the company in January 2008 and (ii) a performance bonus of $102,850 of which $73,150 was paid in cash and $29,700 was paid in 110,000 shares of the Company's common stock valued at the closing price of $.27 on March 13, 2009 quoted on the NYSE Amex which was paid in 2009 for services in 2008. The 2008 bonus amount for Mr. Lurier consists of: (i) a signing bonus of $15,000 when he joined the company in April 2008 and (ii) a performance bonus of $43,695 of which $39,240 was paid in cash and $4,455 was paid in 16,500 shares of the Company's common stock valued at the closing price of $.27 on March 13, 2009 quoted on the NYSE Amex which was paid in 2009 for services in 2008.

(5) Amounts represent the grant date fair value of stock awards and option grants. The 2008 option award amount for Mr. Bender consists of the grant date fair value of an option for 500,000 shares granted upon his joining the company in January 2008. The 2009 stock award amount for Dr. Kornman consists of the grant date fair value of 12,500 shares of our common stock valued at the closing price of $0.28 on March 31, 2009 as quoted on the NYSE Amex. This stock award was vested in full upon grant. The 2008 stock award amount for Dr. Kornman consists of the grant date fair value of 12,500 shares of our common stock valued at the closing price of $1.49 on April 30,

2008 as quoted on the NYSE Amex. This stock award vested in full on March 31, 2009. The 2008 option award amount for Dr. Kornman consists of the grant date fair value of an option for 75,000 shares granted upon the signing of a new employment agreement in November 2008. The 2009 option award amount for Mr. Lurier consists of the grant date fair value of an option for 30,000 shares granted in March 2009. The 2008 option award amount for Mr. Lurier consists of the grant date fair value of an option for 40,000 shares granted upon his joining the company in April 2008.

(6) Mr. Bender received a $1,500 401K company contribution in 2008 and 2009, respectively, and a reimbursement for living expenses amounting to $42,232 and $4,800 in 2008 and 2009, respectively. Dr. Kornman received reimbursement of $2,720 for life insurance in each of 2008 and 2009, and a car allowance of $6,923 and $1,828 in 2008 and 2009, respectively. Mr. Lurier received a $1,500 401K company contribution in 2009.

Narrative Disclosure to Summary Compensation Table

The compensation paid to our named executive officers in 2009 summarized in our Summary Compensation Table above is generally determined in accordance with employment agreements that we have entered into with each of our named executive officers. The material terms of these agreements are discussed under the caption "Employment Agreements" below.

Outstanding Equity Awards at Fiscal Year-End

The following table shows stock option awards outstanding (vested and unvested) and unvested stock awards outstanding as of December 31, 2009, including both awards subject to performance conditions and non-performance-based awards, for each of the executive officers in the Summary Compensation Table.

	Option Awards					Stock Awards			
Name	Number of Securities Underlying Unexercised Options Exercisable (#)	Number of Securities Underlying Unexercised Options Unexercisable (#)	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#)	Options Exercise Price ($)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested ($)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested ($)(1)
Lewis H. Bender	200,000	300,000	—	$ 1.06	1/22/2018	—	—	—	—
Kenneth S. Kornman	150,000	—	—	$ 1.22	4/4/2011	—	—	—	—
	30,000	—	—	$ 0.91	3/17/2012	—	—	—	—
	30,000	—	—	$ 1.65	3/23/2013	—	—	—	—
	30,000	—	—	$ 4.70	12/11/2013	—	—	—	—
	150,000	—	—	$ 4.70	12/11/2013	—	—	—	—
	30,000	—	—	$ 3.65	12/14/2014	—	—	—	—
	—	25,000	—	$ 1.40	4/2/2018	—	—	—	—
	30,000	45,000	—	$ 0.48	11/12/2018	—	—	—	—
Eliot M. Lurier	8,000	32,000	—	$ 1.49	4/30/2018	—	—	—	—
	—	30,000	—	$ 0.27	3/13/2019	—	—	—	—

(1) The market value of the stock awards is determined by multiplying the number of shares times $0.86, the closing price of our common stock on the NYSE Amex, LLC on December 31, 2009, the last trading day of our fiscal year.

Employment Agreements

Lewis H. Bender

Effective as of January 22, 2008, we entered into a two-year employment agreement with Lewis H. Bender for the position of Chief Executive Officer that provided for automatic annual renewal terms. The agreement also provided that Mr. Bender would serve as a member of our Board of Directors for as long as he served as our Chief Executive Officer. The agreement provided for a minimum annual base salary of $340,000, a sign-on bonus of up to $35,000 payable over the first six months of employment and annual, discretionary bonuses of up to 50% of his base salary based upon our financial performance. In addition, the agreement provided for the reimbursement of Mr. Bender's relocation and living expenses for the first twelve months of employment. Upon hire, Mr. Bender was also granted an option to purchase 500,000 shares of our common stock at an exercise price equal to $1.06, the closing price as reported on the NYSE Amex on the effective date of the agreement, which option vests in equal annual installments on the option grant date and February 1 of each of the years 2009, 2011, 2012, and 2013.

On January 21, 2010, we entered into a one-year employment agreement with Mr. Bender to continue as our Chief Executive Officer. The agreement replaced and superseded the employment agreement entered into on January 22, 2008. The agreement has an initial term of one year and is automatically renewable for successive one year periods unless at least 90 days prior notice is given by either us or Mr. Bender. The agreement also provides that Mr. Bender will serve as a member of our Board of Directors for as long as he serves as our Chief Executive Officer, subject to any required approval of our shareholders.

The agreement provides the continuation of Mr. Bender's annual base salary of $340,000 and an annual discretionary bonus of up to 50% of base salary based upon our financial performance. Under the terms of the agreement, Mr. Bender was granted an option to purchase 100,000 shares of our common stock at an exercise price equal to $0.89 per share, the closing price as reported on the NYSE Amex, LLC on the effective date of the agreement, exercisable immediately upon grant.

The agreement is terminable by us for cause or upon thirty days prior written notice without cause and by Mr. Bender upon thirty days prior written notice for "good reason" (as defined in the agreement) or upon ninety days prior written notice without good reason. If we terminate Mr. Bender without cause or Mr. Bender terminates his employment for good reason, then we are required to pay Mr. Bender, in addition to any accrued, but unpaid compensation prior to the termination, an amount equal to eighteen months of his base salary. If we terminates Mr. Bender without cause or Mr. Bender terminates his employment with good reason within six months after a "change of control" (as defined in the agreement), then we are required to pay Mr. Bender, in addition to any accrued, but unpaid compensation prior to the termination, an amount equal to twenty-four months of his base salary, and all unvested stock options will automatically vest.

The agreement also includes non-compete and non-solicitation provisions for a period of twelve months following the termination of Mr. Bender's employment.

Kenneth S. Kornman, DDS, Ph.D.

On November 12, 2008, we entered into an employment agreement with Dr. Kornman, our President and Chief Scientific Officer, for a three-year term, commencing on March 31, 2009, the date his previous employment agreement expired. Under the new agreement, Dr. Kornman received an initial annual salary of $360,000 and is eligible to receive annual bonuses solely at the discretion of the Board of Directors. Dr. Kornman's annual salary may be increased in the sole discretion of the Board of Directors. Under the agreement, on November 12, 2008 Dr. Kornman received a stock option to purchase 75,000 shares of common stock, at an exercise price of $0.48 per share, which was the closing price as reported on the NYSE Amex on the grant date. The option was immediately exercisable with respect to 30,000 shares and vests with respect to an additional 15,000 shares on each of March 31, 2010, 2011, and 2012. Under the agreement, Dr. Kornman is entitled to participate in employee benefit plans that we provide or may establish for the benefit of our executive management generally. In addition, while Dr. Kornman remains employed by us, we will reimburse him $3,296 annually for payment of life insurance premiums.

The agreement is terminable immediately by us with cause or upon thirty days prior written notice without cause. The agreement is terminable by Dr. Kornman upon thirty days prior written notice. If we terminate Dr. Kornman without cause or Dr. Kornman terminates his employment with good reason, then, in addition to payment of any accrued, but unpaid compensation prior to the termination, we must continue to pay his base salary and to provide health insurance benefits until the earlier of (1) expiration of the agreement or (2) twelve months. If we terminate Dr. Kornman in connection with a Cessation of our Business (as defined in the agreement), then, in addition to payment of any accrued, but unpaid compensation prior to the termination, we must continue to pay his base salary and to provide health insurance benefits until the earlier of (1) expiration of the agreement or (2) three months.

The agreement also includes non-compete and non-solicitation provisions for a period of twelve months following the termination of Dr. Kornman's employment.

Eliot M. Lurier

On April 30, 2008, we entered into a one-year employment agreement with Eliot M. Lurier for the position of Chief Financial Officer. The agreement has an initial term of one year and is automatically renewable for successive one year periods unless at least 60 days prior notice is given by either us or Mr. Lurier. The agreement provides for an initial annual base salary of $217,000 which may be increased in the sole discretion of the Compensation Committee of our Board. Mr. Lurier is entitled to annual discretionary bonuses of up to 30% of his base salary in effect during the year for which the bonus relates. Bonuses will be determined by the Compensation Committee of the Board of Directors upon the suggestion of the Chief Executive Officer and will be based upon the employee’s performance and the overall performance of the Company for the year. Mr. Lurier also received a signing bonus of $15,000 after his first four months of employment. On April 30, 2008, Mr. Lurier was granted an option to purchase 40,000 shares of our common stock at an exercise price equal to $1.49, which was the closing price as reported on the NYSE Amex on the grant date. The option vests in equal annual installments of 8,000 shares on each of the first five anniversaries of the grant date.

The agreement is terminable immediately by us with cause or upon thirty days prior written notice if without cause. The agreement is terminable by Mr. Lurier upon thirty days prior written notice. If we terminate Mr. Lurier without cause and at any time following the three-month anniversary of April 30, 2008, then we will pay Mr. Lurier, in addition to any accrued, but unpaid, compensation prior to the termination, an amount equal to six months of his base salary in effect at the time of the termination and six months of continued healthcare coverage, to the same extent that we provided healthcare coverage during his employment, if Mr. Lurier elects to continue participation in our health plan.

The agreement also includes non-compete and non-solicitation provisions for a period of six months following the termination of Mr. Lurier's employment.

Director Compensation

The following table shows the total compensation paid or accrued during the fiscal year ended December 31, 2009 to each of our non-executive directors.

Name (a)	Fiscal Year	Fees Earned or Paid in Cash ($)	Option Awards ($)	All Other Compensation ($)	Total ($)
Mary E. Chowning	2009	$ 33,500	-0-	-0-	$ 33,500

All of our directors are reimbursed for reasonable out-of-pocket expenses incurred in attending Board and committee meetings. Prior to April 29, 2010, Mary E. Chowning was our only director that is a non-employee director and is also not a Series A director. In July 2008, when our board elected Ms. Chowning as a director, we agreed to pay Ms. Chowning the following compensation:

- for service as a director, an annual retainer of $14,000 and $1,500 for each board meeting attended in person, by teleconference or by video;

- for service as the chair of our audit committee, an annual retainer of $7,500 and $1,500 for each audit committee meeting attended in person, by teleconference or by video; and

- for joining us as a director, a grant of 15,000 options to purchase our common stock at an exercise price equal to the closing price of our common stock on the grant date, which vests in equal annual installments on each of the four anniversaries of the grant date.

On April 29, 2010, our Board of Directors elected William C. Mills III as a director and appointed him to our Audit Committee and as the Chair of our Compensation Committee. Mr. Mills joins Ms. Chowning as a non-employee director who is also not a Series A director. In connection with the election of Mr. Mills, the Board adopted the following new policy for compensation of non-employee directors who are also not a Series A director:

- for service as a director, an annual retainer of $20,000;

- for service as the chair of a committee, an annual retainer of $7,500;

- for service as a non-chair member of a committee, an annual retainer of $5,000;

- for each Board or committee meeting attended in person, by teleconference or by video, $1,500; and

-

upon initial election or appointment to the Board, a grant of an option to purchase 15,000 shares of our common stock at an exercise price equal to the closing price of the common stock on the date of grant, with such option to vest in four equal annual installments on each of the first four anniversaries of the grant date.

EQUITY COMPENSATION PLAN INFORMATION

The following table provides certain aggregate information with respect to all of the Company's equity compensation plans in effect as of December 31, 2009.

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders(1)	1,578,917	$ 2.07	1,372,178
Equity compensation plans not approved by security holders	—	—	—
Total	1,578,917	$ 2.07	1,372,178

(1) These plans consist of our 2000 Employee Stock Compensation Plan and our 2004 Employee, Director and Consultant Stock Plan.

AUDIT COMMITTEE REPORT

The Audit Committee of the Board of Directors, which consists entirely of directors who meet the independence and experience requirements of the NYSE Amex, on which the company's shares are listed, has furnished the following report.

The Audit Committee assists the Board in overseeing and monitoring the integrity of our financial reporting process, compliance with legal and regulatory requirements and the quality of internal and external audit processes. The committee's role and responsibilities are set forth in our charter adopted by the Board, which is available on our website at www.ilgenetics.com. The committee reviews and reassesses our charter annually and recommends any changes to the Board for approval. The Audit Committee is responsible for overseeing our overall financial reporting process, and for the appointment, compensation, retention, and oversight of the work of Grant Thornton LLP, our independent public accountants. In fulfilling its responsibilities for the financial statements for the fiscal year ended December 31, 2009, the Audit Committee took the following actions:

- Reviewed and discussed the audited financial statements for the fiscal year ended December 31, 2009 with management and Grant Thornton LLP, our independent public accountants;

- Discussed with Grant Thornton LLP the matters required to be discussed by Statement on Auditing Standards No. 61, as amended, as adopted by the Public Company Accounting Oversight Board in Rule 3200T, relating to the conduct of the audit; and

- Received written disclosures and the letter from Grant Thornton LLP regarding its independence as required by applicable requirements of the Public Company Accounting Oversight Board regarding Grant Thornton LLP's communications with the Audit Committee, and the Audit Committee further discussed with Grant Thornton LLP their independence. The Audit Committee also considered the status of pending litigation, taxation matters and other areas of oversight relating to the financial reporting and audit process that the committee determined appropriate.

Based on the Audit Committee's review of the audited financial statements and discussions with management and Grant Thornton LLP, the Audit Committee recommended to the Board that the audited financial statements be included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009 for filing with the SEC.

MEMBERS OF THE AUDIT COMMITTEE:
Mary E. Chowning (Chair)
Thomas R. Curran, Jr.
James M. Weaver

COMPLIANCE WITH SECTION 16(a) OF THE SECURITIES EXCHANGE ACT OF 1934

Our records reflect that all reports which were required to be filed pursuant to Section 16(a) of the Exchange Act were filed on a timely basis.

CODE OF CONDUCT AND ETHICS

We have adopted a corporate code of conduct and ethics that applies to all of our employees, including our chief executive officer and chief financial officer. The text of the corporate code of conduct and ethics is publicly available on our website at www.ilgenetics.com. Disclosure regarding any amendments to, or waivers from, provisions of the code of conduct and ethics that apply to our directors, principal executive and financial officers will be included in a Current Report on Form 8-K within four business days following the date of the amendment or waiver, unless website posting of such amendments or waivers is then permitted by the rules of the NYSE Amex.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Pursuant to the written charter of our Audit Committee, the Audit Committee is responsible for reviewing and approving, prior to our entry into any such transaction, all transactions in which we are a participant and in which any of the following persons has or will have a direct or indirect material interest: our executive officers; our directors; the beneficial owners of more than 5% of our securities; the immediate family members of any of the foregoing persons; and any other persons whom the Board determines may be considered related persons, any such person being referred to as a “related person.”

The following is a description of arrangements that we have entered into with related persons since January 1, 2008. We believe that the transactions described below were made on terms no less favorable to us than could have been obtained from unaffiliated third parties.

Effective as of September 1, 2008, we and Access Business Group International LLC (ABG), an affiliate of Alticor Inc. and an affiliate of our primary stockholder Pyxis Innovations Inc., amended the formerly exclusive license agreement to render the license non-exclusive, thereby generally allowing us to license our intellectual property to third parties in addition to ABG. The parties also amended the license agreement to remove the right of first negotiation, which we had granted to ABG upon entry into the license agreement, for the commercialization of all of our current and future intellectual property into products/services outside of the field of nutrigenomics and dermagenomics.

On August 17, 2006, we entered into a stock purchase agreement and further amended the note purchase agreement with Pyxis, dated October 23, 2002, to, among other things, provide for the establishment of a $14.3 million convertible credit facility with Pyxis. Subject to certain customary conditions, the agreements contemplated that we could draw down against the convertible credit facility until August 17, 2008. On June 10, 2008, we drew down $4,000,000 under the convertible credit facility, leaving $10.3 million of available credit, and issued a convertible promissory note to Pyxis in that amount. On August 12, 2008, we and Pyxis amended the agreements to extend the expiration date of the credit facility to permit borrowing at any time prior to March 31, 2009. On March 11, 2009, we entered into an amended and restated note purchase agreement, dated as of March 10, 2009, with Pyxis to extend the availability of the credit facility until March 31, 2010. In 2009, we drew down $3.0 million under this credit facility, leaving $7.3 million of remaining availability. On February 1, 2010, we drew down $2.0 million under the credit facility leaving $5.3 million of remaining availability. In addition, the credit line was extended to permit borrowing at any time prior to June 30, 2011. All such borrowing becomes due on August 16, 2011 and are convertible into shares of common stock at a conversion price equal to $5.68 per share.

On February 25, 2008, the Company entered into a research agreement (RA8) with an affiliate of Alticor, effective January 1, 2008, to expand the research being performed under its current agreements with Alticor through 2008. The Company received $1,200,000 during 2008 under the research agreement, on a time and materials basis. On January 31, 2009, the Company entered into an amendment to the RA8. The amendment extended the term from a maximum of six months to eight months, terminating on September 30, 2009. The Company received an additional $200,316 on March 31, 2009 under the terms of the amendment to complete ongoing research. At December 31, 2009, all research agreements with Alticor were complete.

On October 26, 2009, we entered into a Merchant Network and Channel Partner Agreement with Amway Corp. d/b/a Amway Global, a subsidiary of Alticor Inc. Pursuant to this Agreement, Amway Global will sell our Inherent Health brand of genetic tests through its e-commerce Web site via a hyperlink to our e-commerce site. Amway Global will receive a commission equal to a percentage of net sales received by us from Amway Global customers. The agreement has an initial term of 12 months and is automatically renewable for successive 12-month terms. The agreement may be terminated by either party upon 120 days written notice. To date, we have paid Amway Global approximately $116,000 in commissions under this agreement.

For additional information with respect to the holdings of our primary stockholder, Pyxis Innovations Inc., see “Security Ownership of Certain Beneficial Owners and Management.”

PROPOSAL 1

TO ELECT WILLIAM C. MILLS III AS A CLASS I DIRECTOR

Our Board of Directors currently consists of seven directors. Pursuant to our charter, the holders of shares of our Series A Preferred Stock are entitled to elect up to four directors to our Board of Directors (the “Series A Directors”), who are not apportioned among classes. Each of the Series A Directors is nominated and elected by Pyxis Innovations Inc., as the sole holder of shares of our Series A Preferred Stock. James M. Weaver, Glenn S. Armstrong, George D. Calvert, and Thomas R. Curran are our current Series A Directors. Our Board of Directors currently includes three directors who are not Series A Directors and who are classified into three classes as follows: (1) William C. Mills III, serves as a Class I director with a term ending at this annual meeting, (2) Lewis H. Bender serves as a Class II director with a term ending at the 2011 annual meeting, and (3) Mary E. Chowning serves as a Class III director with a term ending at the 2012 annual meeting.

The Board of Directors, upon the recommendation of the Nominating Committee, has voted to nominate Mr. Mills for election at the 2010 annual meeting for a term of three years to serve until the 2013 annual meeting, and until his successor is elected and qualified. Mr. Bender, as a Class II director, will continue to serve until the 2011 annual meeting, and Ms. Chowning, as a Class III director, will serve until the 2012 annual meeting, and, in each case, until their respective successors have been elected and qualified.

Unless authority to vote for Mr. Mills is withheld, the shares represented by the enclosed proxy will be voted FOR the election as director of Mr. Mills. In the event that the nominee becomes unable or unwilling to serve, the shares represented by the enclosed proxy will be voted for the election of such other person as the Board of Directors may recommend in his place. We have no reason to believe that Mr. Mills will be unable or unwilling to serve as a director.

A plurality of the shares voted is required to elect Mr. Mills.

The Board of Directors recommends a vote "FOR" the election of William C. Mills III as a Class I director, and proxies solicited by the Board will be voted in favor, unless a stockholder indicates otherwise on the proxy.

PROPOSAL 2

RATIFICATION OF APPOINTMENT OF INDEPENDENT PUBLIC ACCOUNTANT

The Audit Committee of the Board has appointed Grant Thornton LLP as our independent public accountant for the fiscal year ending December 31, 2010. The Board proposes that the stockholders ratify this appointment. Grant Thornton LLP has audited the Company's financial statements since 2002. We expect that representatives of Grant Thornton LLP will be present at the meeting, will be able to make a statement if they so desire, and will be available to respond to appropriate questions.

Principal Accountant Fees And Services

The following table presents fees for professional audit services rendered by Grant Thornton, LLP for the audit of our annual financial statements for the years ended December 31, 2009 and December 31, 2008 and fees billed for other services rendered by Grant Thornton LLP during those periods.

	2009	2008
Audit fees(1)	$ 238,541	$ 303,245
Audit related fees	41,811	—
Tax fees	—	—
All other fees(2)	7,787	7,385
Total	$ 288,139	$ 310,630

(1) Audit fees consist of fees for professional services rendered for the audit of our annual financial statements, a review of the interim financial statements included in the quarterly reports and a review of internal controls over financial reporting (Section 404 of the Sarbanes-Oxley Act of 2002).

(2) All other fees consist of non audit service fees paid to our audit firm and approved by our audit committee.

Policy on Audit Committee Pre-Approval of Audit and Permissible Non-audit Services of Independent Auditors

Consistent with SEC policies regarding auditor independence, the Audit Committee has responsibility for appointing, setting compensation and overseeing the work of the independent auditor. In recognition of this responsibility, the Audit Committee has established a policy to pre-approve all audit and permissible non-audit services provided by the independent auditor.

Prior to the engagement of the independent auditor for the next year's audit, management will submit to the Audit Committee for approval a summary of the services expected to be rendered during that year for each of four categories of services.

1. Audit services include audit work performed in the preparation of financial statements, as well as work that generally only the independent auditor can reasonably be expected to provide, including comfort letters, statutory audits, and attest services and consultation regarding financial accounting and/or reporting standards.

2. Audit-Related services are for assurance and related services that are traditionally performed by the independent auditor, including due diligence related to mergers and acquisitions, employee benefit plan audits, and special procedures required to meet certain regulatory requirements.

3. Tax services include all services performed by the independent auditor’s tax personnel except those services specifically related to the audit of the financial statements, and includes fees in the areas of tax compliance, tax planning, and tax advice.

4. Other Fees are those associated with services not captured in the other categories. The Company generally does not request such services from the independent auditor.

Prior to the engagement, the Audit Committee pre-approves these services by category of service. The fees are budgeted and the Audit Committee requires the independent auditor and management to report actual fees versus the budget periodically throughout the year by category of service. During the year, circumstances may arise when it may become necessary to engage the independent auditor for additional services not contemplated in the original pre-approval. In those instances, the Audit Committee requires specific pre-approval before engaging the independent auditor.

The Audit Committee may delegate pre-approval authority to one or more of its members. The member to whom such authority is delegated must report, for informational purposes only, any pre-approval decisions to the Audit Committee at its next scheduled meeting.

Neither our Bylaws nor other governing documents or law require stockholder ratification of the appointment of Grant Thornton LLP as the Company’s independent public accountant. However, the Board is submitting the appointment of Grant Thornton LLP to the stockholders for ratification as a matter of good corporate practice. If the stockholders fail to ratify the appointment, the Audit Committee of the Board will reconsider whether to retain Grant Thornton LLP as the Company’s independent public accountant. Even if the selection is ratified, the Audit Committee of the Board in its discretion may direct the appointment of a different independent public accountant at any time during the year if the Audit Committee determines that such a change would be in the best interests of the company and its stockholders.

The affirmative vote of the holders of a majority of the shares present in person or represented by proxy and entitled to vote at the annual meeting will be required to ratify the appointment of Grant Thornton LLP as our independent public accountant.

The Board of Directors recommends a vote “FOR” ratification of the appointment of Grant Thornton LLP as our independent public accountant, and proxies solicited by the Board will be voted in favor of such ratification unless a stockholder indicates otherwise on the proxy.

OTHER MATTERS

The Board of Directors knows of no other business which will be presented at the annual meeting. If any other business is properly brought before the annual meeting, proxies in the enclosed form will be voted in accordance with the judgment of the persons named therein.

STOCKHOLDER PROPOSALS AND NOMINATIONS FOR DIRECTOR

To be considered for inclusion in the proxy statement relating to our 2011 Annual Meeting of Stockholders, stockholder proposals, including nominations for director, must be received no later than January 11, 2011. To be considered for presentation at the 2011 Annual Meeting, although not included in the proxy statement, proposals must be received no later than April 18, 2011 and not before March 19, 2011. Proposals received in a timely manner will not be voted on at the 2011 Annual Meeting. If a timely proposal is received, the proxies that management solicits for the meeting may still exercise discretionary voting authority on the proposal under circumstances consistent with the proxy rules of the SEC. All stockholder proposals and nominations for director should be marked for the attention of Secretary, Interleukin Genetics, Inc., 135 Beaver Street, Waltham, Massachusetts 02452.

Waltham, Massachusetts
April 29, 2010

Our Annual Report on Form 10-K, which includes our financial statements, for the fiscal year ended December 31, 2009, and which provides additional information about us can be found on the website of the Securities and Exchange Commission at www.sec.gov. It is also available on our website at www.ilgenetics.com. You may obtain a printed copy of our Annual Report on Form 10-K, including our financial statements, free of charge, from us by sending a written request to: Investor Relations, Interleukin Genetics, Inc., 135 Beaver Street, Waltham, Massachusetts 02452. Exhibits will be provided upon written request and payment of an appropriate processing fee.