

HALLADOR PETROLEUM CO
Form 10KSB
April 14, 2006

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

FORM 10-KSB

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended: **December 31, 2005**

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number: 0-14731

HALLADOR PETROLEUM COMPANY

COLORADO
(State of incorporation)

84-1014610
(IRS Employer Identification No.)

1660 Lincoln Street, Suite 2700, Denver, Colorado
(Address of principal executive offices)

80264-2701
(Zip Code)

Issuer's telephone number: 303.839.5504

Fax: 303.832.3013

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

Securities registered under Section 12(g) of the Exchange Act: Common Stock, \$.01 par value

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.

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

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

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

Our revenue from continuing operations for the year ended December 31, 2005 was about \$1.1 million.

At April 4, 2006, we had 12,168,135 shares outstanding and the aggregate market value of such shares held by non-affiliates was about \$4 million based on a closing price of \$4.10.

DOCUMENTS INCORPORATED BY REFERENCE: NONE

ITEM 1. DESCRIPTION OF BUSINESS

General Development of Business

Hallador Petroleum Company (Hallador), a Colorado corporation, was organized by our predecessor in 1949.

About nine years ago, Yorktown Energy Partners II and affiliates (Yorktown) invested \$5,025,000 in Hallador Petroleum, LLP, a newly formed limited liability limited partnership, (the "Partnership"). We are the general partner and received a 70% interest in the partnership in return for contributing our net assets and Yorktown representing the limited partners, received a 30% interest for its \$5,025,000 cash contribution. During the third quarter of 2005, we purchased the limited partners interest in the Partnership, and for accounting purposes the Partnership no longer exists and, as a result, there is no longer a minority interest caption on our balance sheet. Prior to this transaction we, as general partner, consolidated the activity of the Partnership and presented the 30% limited partners' interest as a minority interest.

On August 10, 2004, we entered into an agreement with E&B Natural Resources Management Corporation (a private company) to sell all of our interest in the South Cuyama field and adjacent exploration areas, all located in Santa Barbara County, California, for \$23 million; consisting of \$19.5 million in cash and an interest bearing (3.5%) note of \$3.5 million due on September 30, 2005, which was paid. Closing occurred on September 30, 2004 and we recorded a pre-tax gain of about \$14 million. Results from the South Cuyama field have been presented as discontinued operations in the accompanying Consolidated Statement of Operations.

Due to the sale, our board of directors and the Executive Committee of the Partnership, voted to discontinue new partnership operations effective October 1, 2004. At that time, the Partnership's assets consisted of cash, the \$3.5 million note receivable, oil and gas properties in New Mexico and Texas, and other miscellaneous assets. On October 1, 2004, our board of directors and the Executive Committee of the Partnership, valued the oil and gas properties in New Mexico and Texas and the other miscellaneous assets at \$4 million. On May 6, 2005 we made a cash distribution of about \$5.2 million to the limited partners. During the third quarter 2005, we purchased the limited partners' interest in the Partnership for about \$1.2 million and made a final cash distribution to the limited partners of \$1.6 million. After these transactions, about \$1.7 million remained in the minority interest account and was recorded as a reduction in our accumulated deficit account.

In late March 2005, we invested \$325,000 for a 29% interest in a newly formed entity called COALition Energy, LLC (CELLC) to pursue coal opportunities in the United States. Some of our officers and directors also invested in CELLC.

We have concluded to deemphasize our oil and gas operations and concentrate our future efforts in the coal business. With that in mind, the following events have occurred:

1. In early January 2006, we signed a Letter of Intent with Sunrise Coal, LLC (Sunrise) in order to effect a reorganization/merger between Hallador and Sunrise, a private company not affiliated with the Yorktown group of companies. We are working on a formal agreement which we hope to execute sometime in the second quarter 2006. Upon closing, it is expected that our existing shareholders will own about 52% and the Sunrise shareholders will own about 48% of the new company.

CELLC brought us the Sunrise deal and, upon closing, they will receive a finders fee, stock and warrants in the new company.

During the first quarter of 2006, we loaned Sunrise \$7 million in order for Sunrise to begin development of their second coal mine (the "Carlisle mine"). Their Howesville mine began producing coal in November 2005. Both mines are located in Indiana. During the second quarter of 2006, Sunrise expects to enter into a \$30 million line-of-credit with two Indiana banks, at which time our \$7 million will be repaid. We have agreed to guarantee this \$30 million line-of-credit.

2. In late February 2006, we sold 3,181,816 shares for \$2.20 per share (about \$7 million) to our existing shareholders. The proceeds will provide working capital for the Sunrise transaction.

With regards to our oil and gas business, the following events have occurred:

1. In August 2005, we began negotiations to purchase from Yorktown Energy Partners II, LP its 32% interest in Savoy Energy LLP, a private company engaged in the oil and gas business primarily in the State of Michigan. A purchase price of \$4.1 million was agreed upon and closing occurred on December 31, 2005. On December 20, 2005 we sold about 1,893,000 shares of our common stock to Yorktown Energy Partners VI LP at \$2.20 per share (about \$4.1 million). We will account for our interest in Savoy using the equity method of accounting.

2. In December 2005, we sold substantially all of our interest in our North Dakota properties for about \$1.6 million, which was our original investment; accordingly, no gain or loss was recognized.

3. In late March 2006, we signed a letter-of-intent with Approach Resources Inc., to sell them all our interests in our Albany Shale prospect located in Kentucky. If we close this transaction, we expect to recognize a gain of about \$600,000 and our cash proceeds will be about \$3.3 million. Approach Resources Inc., based in Fort Worth, Texas, has an affiliation with the Yorktown group of companies.

Our office is located at 1660 Lincoln Street, Suite 2700, Denver, Colorado 80264, phone 303.839.5504, fax 303.832.3013. We have no website.

Until we close the Sunrise deal, there is no need to discuss the coal business and the rest of this discussion will be about our oil and gas operations.

We operate oil and natural gas properties for our own account and for the account of others. We also review and evaluate producing oil and natural gas properties, companies, or other entities, which meet certain guidelines for acquisition purposes. Occasionally, we engage in the trading and acquisition of non-producing oil and gas mineral leases and fee-simple minerals.

Markets

Our products are sold to various purchasers in the geographic area of the properties. Natural gas, after processing, is distributed through pipelines. Oil and natural gas liquids (NGLs) are distributed through pipelines or hauled by trucks. The principal uses for oil and natural gas are heating, manufacturing, power, and transportation.

Competition

The oil and gas industry is highly competitive. We encounter competition from major and independent oil companies in acquiring economically desirable producing properties, drilling prospects, and even the equipment and labor needed to drill, operate and maintain our properties. Competition is intense with respect to the acquisition of producing and partially developed properties. We compete with companies having financial resources and technical staffs significantly larger than our own. We do not own any refining or retail outlets and have minimal control over the prices of our products. Generally, higher costs, fees and taxes assessed at the producer level cannot be passed on to our customers.

We also face competition from imported products as well as alternative sources of energy such as coal, nuclear, hydro-electric power, and a growing trend toward solar. We could incur delays or curtailments of the purchase of our available production. We may also encounter increasing costs of production and transportation while sale prices remain stable or decline. Any of these competitive factors could have an adverse effect on our operating results.

Environmental and Other Regulations

Our operations are affected in varying degrees by federal, state, regional and local laws and regulations, including, but not limited to, laws governing allowable rates of production, well spacing, air emissions, water discharges, endangered species, marketing, prices and taxes. We are further affected by changes in such laws and by constantly changing administrative regulations.

Most natural gas pricing is presently deregulated and the remaining regulation has no material impact on our prices. We cannot predict the long-term impact of future natural gas price regulation or deregulation.

We are subject to various federal, state, regional and local laws and regulations relating to discharge of materials into, and protection of, the environment. These laws and regulations may, among other things, impose liability on the owner or the lessee for the cost of pollution clean-up resulting from operations, subject the owner or lessee to liability for pollution damages, require suspension or cessation of operations in affected areas or impose restrictions on injection into subsurface aquifers that may contaminate groundwater. Such regulation has increased the resources required in, and costs associated with, planning, designing, drilling, installing, operating and abandoning our oil and natural gas wells and other facilities.

We have and will continue to make expenditures to comply with these requirements, which we believe are necessary business costs. Although environmental requirements do have a substantial impact upon the energy industry, generally these requirements do not appear to affect us any differently or to any greater or lesser extent than other companies.

Although we are not fully insured against all environmental and other risks, we maintain insurance coverage, which we believe, is customary in the industry.

During 2005, the cost to comply with these recurring environmental regulations were not significant to our continuing operations and are not expected to be in the foreseeable future.

To the extent these environmental expenditures reduce funds available for increasing our reserves of oil and natural gas, future operations could be adversely impacted. Despite the fact that all of our competitors have to comply with similar regulations, many are much larger and have greater resources with which to deal with these regulations.

Other

We have no significant patents, trademarks, licenses, franchises or concessions.

The oil business is not generally seasonal in nature; although unusual weather extremes for extended periods may increase or decrease demand. Natural gas prices tend to increase in the fall and winter months and to decrease in the spring and summer.

We have four full-time employees and two part-time employees. When needed we also engage consulting petroleum engineers, environmental professionals, geologists, geophysicists, landmen, accountants and attorneys on a fee basis.

ITEM 2. DESCRIPTION OF PROPERTY

Location and General Character

Our primary operating property is in the San Juan Basin, located in the northwest corner of New Mexico.

We hold our working interests in oil and natural gas properties either through recordable assignments, leases, or contractual arrangements such as operating agreements. Consistent with industry practices, we do not make a detailed examination of title when we acquire undeveloped acreage. Title to such properties is examined by legal counsel prior to commencement of drilling operations. This method of title examination is consistent with industry practices.

In the acquisition and operation of oil and natural gas properties, burdens such as royalty, overriding royalty, liens incident to operating agreements, liens by taxing authorities, as well as other burdens and minor encumbrances are customarily created. We believe that no such burdens materially affect the value or use of our properties.

Savoy's oil and gas properties are located primarily in the State of Michigan. Savoy's condensed financial statements are presented in Note 5 to our financial statements and Savoy's condensed oil and gas reserve information is presented in Note 6 to our financial statements.

Proved Oil and Gas Reserves

Information concerning our reserve estimates is set forth in Note 6 to the consolidated financial statements. Our reserve estimates were prepared by a sole-proprietor consulting petroleum engineer and Savoy's reserve estimates were prepared by Netherland, Sewell & Associates. All of our and Savoy's reserves are located onshore.

Sales and Price Data

See Item 6 – MD&A

Producing Wells

As of April 4, 2006, we had a working interest in 32 gross (3 net) gas wells.

Leasehold Interests

The following table sets forth our gross and net acres of undeveloped oil and gas leases as of April 4, 2006:

| | | Gross | | Net | |
|--|--|-------|--|-----|--|
| | | | | | |

| | | | | |
|--|----------|--------|--------|--|
| | Kentucky | 66,279 | 65,903 | |
|--|----------|--------|--------|--|

| | | | | |
|--|---------|--------|--------|--|
| | Montana | 34,474 | 28,854 | |
|--|---------|--------|--------|--|

| | | |
|--------------|---------|---------|
| North Dakota | 812 | 121 |
| Wyoming | 44,324 | 36,784 |
| Other | 238 | 25 |
| Total | 146,127 | 131,687 |

Drilling Activity - Continuing Operations

During 2005, we drilled two development gas wells, the Horton 1C and the Horton 1D, located in the San Juan Basin. We have about a 6% WI in each well.

Nothing has been drilled so far in 2006.

During 2004, there was no drilling activity.

ITEM 3. LEGAL PROCEEDINGS: None

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS: None

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PART II**ITEM 5. MARKET FOR COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the OTC Bulletin Board under the symbol "HPCO". The following table sets forth the high and low sales price for the periods indicated:

| | High | Low |
|-------------------------------------------|---------|---------|
| 2006 (January 1 through April 4, 2006) | \$ 4.10 | \$ 3.10 |
| 2005 | | |
| First quarter | 2.15 | 2.10 |
| Second quarter | 3.40 | 1.75 |
| Third quarter | 8.00 | 2.06 |
| Fourth quarter | 3.99 | 2.00 |
| 2004 | | |
| First quarter | 1.55 | 1.15 |
| Second quarter | 5.15 | 1.35 |
| Third quarter | 3.00 | 2.10 |
| Fourth quarter | 3.05 | 2.10 |

During the last two years no dividends were paid. We have no present intention to pay any dividends in the foreseeable future.

At April 4, 2006 there were 393 holders of record of our common stock and the last recorded sales price was \$4.10.

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

Overview

Our consolidated financial statements should be read in conjunction with this discussion. Our primary operating property is in the San Juan Basin, located in the northwest corner of New Mexico. Due to the sale of the South Cuyama field in 2004, as discussed below, we are engaged in the exploration, development and production of oil and natural gas in the Rocky Mountain region. We also have a 32% equity interest in an oil and gas company which has operations in Michigan. We have concluded to deemphasize our oil and gas operations and concentrate our future efforts in the coal business.

What follows is a timeline that tells where we have been and where we plan to go.

About nine years ago, Yorktown Energy Partners II and affiliates (Yorktown) invested \$5,025,000 in Hallador Petroleum, LLP, a newly formed limited liability limited partnership, (the "Partnership"). We are the general partner and received a 70% interest in the partnership in return for contributing our net assets and Yorktown representing the limited partners, received a 30% interest for its \$5,025,000 cash contribution. During the third quarter of 2005, we purchased the limited partners interest in the Partnership, and for accounting purposes the Partnership no longer exists and, as a result, there is no longer a minority interest caption on our balance sheet. Prior to this transaction we, as general partner, consolidated the activity of the Partnership and presented the 30% limited partners' interest as a minority interest.

On August 10, 2004, we entered into an agreement with E&B Natural Resources Management Corporation (a private company) to sell all of our interest in the South Cuyama field and adjacent exploration areas, all located in Santa Barbara County, California, for \$23 million; consisting of \$19.5 million in cash and an interest bearing (3.5%) note of \$3.5 million due on September 30, 2005, which was paid. Closing occurred on September 30, 2004 and we recorded a pre-tax gain of about \$14 million. Results from the South Cuyama field have been presented as discontinued operations in the accompanying Consolidated Statement of Operations; revenue and expenses before the minority interest were about \$7 million and \$5 million, respectively for 2004.

Due to the sale, our board of directors and the Executive Committee of the Partnership, voted to discontinue new partnership operations effective October 1, 2004. At that time, the Partnership's assets consisted of cash, the \$3.5 million note receivable, oil and gas properties in New Mexico and Texas, and other miscellaneous assets. On October 1, 2004, our board of directors and the Executive Committee of the Partnership, valued the oil and gas properties in New Mexico and Texas and the other miscellaneous assets at \$4 million. On May 6, 2005 we made a cash distribution of about \$5.2 million to the limited partners. During the third quarter 2005, we purchased the limited partners' interest in the Partnership for about \$1.2 million and made a final cash distribution to the limited partners of \$1.6 million. After these transactions, about \$1.7 million remained in the minority interest account and was recorded as a reduction in our accumulated deficit account.

In late March 2005, we invested \$325,000 for a 29% interest in a newly formed entity called COALition Energy, LLC (CELLC) to pursue coal opportunities in the United States. Some of our officers and directors also invested in CELLC.

Significant Transactions

1. In early January 2006, we signed a Letter of Intent with Sunrise Coal, LLC (Sunrise) with the intent to effect a reorganization/merger between Hallador and Sunrise a private company not affiliated with the Yorktown group of companies. We are working on a formal agreement which we hope to execute sometime in the second quarter 2006. Upon closing, it is expected that our existing shareholders will own about 52% and the Sunrise shareholders will own about 48% of the new company.

CELLC brought us the Sunrise deal and, upon closing, they will receive a finders fee, stock and warrants in the new company.

During the first quarter of 2006, we loaned Sunrise \$7 million in order for Sunrise to begin development of their second coal mine (the "Carlisle mine"). Their Howesville mine began producing coal in November 2005. Both mines are located in Indiana. During the second quarter of 2006, Sunrise expects to enter into a \$30 million line-of-credit with two Indiana banks, at which time our \$7 million will be repaid. We have agreed to guarantee this \$30 million line-of-credit.

2. In late February 2006, we sold 3,181,816 shares for \$2.20 per share (about \$7 million) to our existing shareholders. The proceeds were used to make the bridge loan discussed above.

With regards to our oil and gas business, the following events have occurred:

1. In August 2005, we began negotiations to purchase from Yorktown Energy Partners II, LP its 32% interest in Savoy Energy LLP, a private company engaged in the oil and gas business primarily in the State of Michigan. A purchase price of \$4.1 million was agreed upon and closing occurred on December 31, 2005. On December 20, 2005 we sold about 1,893,000 shares of our common stock to Yorktown Energy Partners VI, L.P. at \$2.20 per share (about \$4.1 million). We will account for our interest in Savoy using the equity method of accounting.

2. In December 2005, we sold substantially all of our interest in our North Dakota properties for about \$1.6 million, which was our original investment; accordingly, no gain or loss was recognized.

3. In late March 2006, we signed a letter-of-intent with Approach Resources Inc., to sell them all our interests in our Albany Shale prospect located in Kentucky. If we close this transaction, we expect to recognize a gain of about \$600,000 and our cash proceeds will be about \$3.3 million. Approach Resources Inc., based in Fort Worth, Texas, has an affiliation with the Yorktown group of companies.

Our profitability in any particular accounting period will be directly related to: (i) prices, (ii) production, (iii) lifting costs, and (iv) exploration activities. Accordingly, operating results will fluctuate from period to period based on these factors, among others.

What follows is a discussion of our primary operating area.

San Juan Basin

This gas field is located in the northwest corner of New Mexico in San Juan County. We have an interest in 28 wells and are the operator. These wells have long-lived reserves. Our WI in this field ranges from 5%-15% with NRIs between 5%-13%. At December 31, 2005, our net book value in this prospect was about \$600,000. We assigned proved developed gas reserves to this field of about 1.3 BCF to our interest.

Investments Made In 2005

In December 2005, we sold substantially all of our interest in North Dakota for \$1.6 million which was our original cost, and accordingly, no gain or loss was recognized.

Coal

In late March 2005, we invested \$325,000 for a 29% interest in a newly formed entity called COALition Energy, LLC (CELLC). CELLC was formed to pursue coal investments. Mr. Stabio, Mr. Dietler, Mr. David Hardie and Mr. Steven Hardie, of our board of directors, also invested in CELLC on the same terms as we did, and collectively they own about 14%. Kestrel Energy Partners, which Yorktown Energy Partners, LLC, has invested in, has a 20% interest in CELLC. We provide offices and administrative services for CELLC. Gerald Schissler, CEO, age 61 and Jerry Vaninetti, COO, age 56, both of which have extensive experience in the coal industry are contract employees of CELLC. At payout, these two individuals, will each earn a 10% interest in CELLC.

As discussed above, CELLC will receive a finders fee upon the closing of the Sunrise deal.

Albany Shale Gas Lease Play

During 2005, we have invested about \$2.8 million in this wildcat gas lease play located in Western Kentucky. To date we have leased about 65,000 acres. Over 80% of the acreage is held under five-year leases with the right to extend for another five years by paying \$2 per acre per year. As discussed above, we hope to sell this prospect to Approach Resources, Inc. sometime in April 2006. Under the letter of intent, Approach is to drill and complete three exploratory gas wells at no cost to us, other than minimal acreage costs. Upon completion we will have a one third (1/3) interest in each well and have the right to repurchase a one third (1/3) interest in future drilling prospects at the ground floor cost.

Liquidity and Capital Resources

To date, we have incurred significant accounting and legal fees (\$150,000) in connection with the Sunrise deal and such fees will continue until closing occurs. At December 31, 2005, we capitalized \$21,000 in such costs, and if closing does not occur, such costs will be expensed.

Cash and cash to be provided from operations are expected to enable us to meet our obligations as they become due during the next several years.

We have no bank debt, no special purpose entities and no off-balance sheet arrangements.

As discussed above, we have entered into significant related party transactions with the Yorktown group of companies. Yorktown and its affiliates currently own about 54% of our common stock and represents one of the five seats on our board.

Results Of Continuing Operations

The table below provides sales data and average prices for the period.

| | Sales Volume | 2005 Average Price | Revenue | Sales Volume | 2004 Average Price | Revenue |
|-------------|-----------------|--------------------------|------------|-----------------|--------------------------|------------|
| Gas-mcf | | | | | | |
| San Juan | 62,515 | \$ 10.81 | \$ 675,800 | 68,500 | \$ 7.66 | \$ 524,700 |
| Other | 41,000 | 8.20 | 336,200 | 48,480 | 6.13 | 297,200 |
| Oil-barrels | | | | | | |
| San Juan | 110 | 49.09 | 5,400 | 105 | 28.58 | 3,000 |
| Other | 1,565 | 54.31 | 85,000 | 2,030 | 39.41 | 80,000 |

Revenue increased due to higher prices. The higher prices more than offset the decline in production as indicated above. San Juan natural gas is sold at an index price that is set at the first of every month and remains in effect for the entire month. Our San Juan March 2006 price is about \$7.26 per MCF.

Interest income increased due to investing the proceeds from the sale that occurred in September 2004.

General and administrative expenses declined due to the termination of two employees after the California property sale, and salary reductions in the Denver office. Our CEO's salary was reduced 26% and certain other employees' salaries were reduced 10%.

Critical Accounting Policies and Estimates

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements.

Successful Efforts Method of Accounting

We account for our exploration and development activities utilizing the successful efforts method of accounting. Under this method, costs of productive exploratory wells, development dry holes and productive wells and undeveloped leases are capitalized. Oil and gas lease acquisition costs are also capitalized. Exploration costs, including personnel costs, certain geological and geophysical expenses and delay rentals for oil and gas leases, are charged to expense as incurred. Exploratory drilling costs are initially capitalized, but charged to expense if and when the well is determined not to have found reserves in commercial quantities. The sale of a partial interest in a proved property is accounted for as a cost recovery and no gain or loss is recognized as long as this treatment does not significantly affect the unit-of-production amortization rate. A gain or loss is recognized for all other sales of producing properties.

The application of the successful efforts method of accounting requires managerial judgment to determine the proper classification of wells designated as developmental or exploratory which will ultimately determine the proper accounting treatment of the costs incurred. The results from a drilling operation can take considerable time to analyze and the determination that commercial reserves have been discovered requires both judgment and industry experience. Wells may be completed that are assumed to be productive and actually deliver oil and gas in quantities insufficient to be economic, which may result in the abandonment of the wells at a later date. Wells are drilled that have targeted geologic structures that are both developmental and exploratory in nature and an allocation of costs is required to properly account for the results. The evaluation of oil and gas leasehold acquisition costs requires managerial judgment to estimate the fair value of these costs with reference to drilling activity in a given area. Drilling activities in an area by other companies may also effectively condemn leasehold positions.

The successful efforts method of accounting can have a significant impact on the operational results reported when we enter a new exploratory area in hopes of finding an oil and gas field that will be the focus of future development drilling activity. The initial exploratory wells may be unsuccessful and will be expensed. Seismic costs can be substantial which will result in additional exploration expenses when incurred.

Reserve Estimates

Our estimates of oil and gas reserves, by necessity, are projections based on geologic and engineering data, and there are uncertainties inherent in the interpretation of such data as well as the projection of future rates of production and the timing of development expenditures. Reserve engineering is a subjective process of estimating underground accumulations of oil and gas that are difficult to measure. The accuracy of any reserve estimate is a function of the quality of available data, engineering and geological interpretation and judgment. Estimates of economically recoverable oil and gas reserves and future net cash flows necessarily depend upon a number of variable factors and assumptions, such as historical production from the area compared with production from other producing areas, the assumed effects of regulations by governmental agencies and assumptions governing future oil and gas prices, future operating costs, severance taxes, development costs and workover costs, all of which may in fact vary considerably from actual results. The future drilling costs associated with reserves assigned to proved undeveloped locations may ultimately increase to an extent that these reserves may be later determined to be uneconomic. For these reasons, estimates

of the economically recoverable quantities of oil and gas attributable to any particular group of properties, classifications of such reserves based on risk of recovery, and estimates of the future net cash flows expected therefrom may vary substantially. Any significant variance in the assumptions could materially affect the estimated quantity and value of the reserves, which could affect the carrying value of our oil and gas properties and/or the rate of depletion of the oil and gas properties. Actual production, revenues and expenditures with respect to our reserves will likely vary from estimates, and such variances may be material.

Impairment of Developed Oil and Gas Properties

We review our oil and gas properties for impairment whenever events and circumstances indicate a decline in the recoverability of their carrying value. We estimate the expected future cash flows of our oil and gas properties and compare such future cash flows to the carrying amount of our oil and gas properties to determine if the carrying amount is recoverable. If the carrying amount exceeds the estimated undiscounted future cash flows, we will adjust the carrying amount of the oil and gas properties to their fair value. The factors used to determine fair value include, but are not limited to, estimates of proved reserves, future commodity pricing, future production estimates, anticipated capital expenditures, and a discount rate commensurate with the risk associated with realizing the expected cash flows projected.

Impairment of Unproved Oil and Gas Properties

We periodically assess individually significant unproved oil and gas properties for impairment, on a project-by-project basis. Our assessment of the results of exploration activities, commodity price outlooks, planned future sales or expiration of all or a portion of such projects impact the amount and timing of impairment provisions.

New Accounting Pronouncements

In December 2004, the FASB issued SFAS 123(R) that requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. That cost will be measured based on the fair value of the equity or liability instrument issued. SFAS 123(R) covers a wide range of share-based awards, stock appreciation rights, and employee stock purchase plans. SFAS 123(R) replaces SFAS 123, "Accounting for Stock-Based Compensation," and supersedes APB Opinion 25, "Accounting for Stock Issued to Employees." We will be required to apply SFAS 123(R) in the first quarter 2006, and will use the modified prospective method of adoption. We had \$1,035,000 of unvested compensation related to outstanding stock options and estimate having to expense \$115,000 during the first quarter of 2006.

None of the other FASB pronouncements issued during the last two years had, or will have, any effect on us.

ITEM 7. FINANCIAL STATEMENTS

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**REPORT OF INDEPENDENT REGISTERED
PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders
Hallador Petroleum Company
Denver, Colorado

We have audited the consolidated balance sheet of Hallador Petroleum Company and Subsidiaries as of December 31, 2005 and the consolidated statements of operations and cash flows for the years ended December 31, 2005 and 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial condition of Hallador Petroleum Company and Subsidiaries, as of December 31, 2005 and the results of their operations and their cash flows for the years ended December 31, 2005 and 2004, in conformity with accounting principles generally accepted in the United States of America.

/s/ Ehrhardt Keefe Steiner & Hottman PC

March 31, 2006
Denver, Colorado

Consolidated Balance Sheet

December 31, 2005

(in thousands)

ASSETS

Current assets:

| | | |
|---------------------------|----|--------|
| Cash and cash equivalents | \$ | 12,261 |
| Accounts receivable- | | |
| Oil and gas sales | | 950 |
| Well operations | | 1,198 |
| Total current assets | | 14,409 |

Oil and gas properties, at cost (successful efforts):

| | | |
|-------------------------------------------------------------------------|----|---------|
| Unproved properties | | 2,909 |
| Proved properties | | 2,388 |
| Less – accumulated depreciation, depletion, amortization and impairment | | (1,776) |
| | | 3,521 |
| Investment in CELLC | | 223 |
| Investment in Savoy | | 4,205 |
| Other assets | | 246 |
| | \$ | 22,604 |

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:

| | | |
|------------------------------------------|----|-------|
| Accounts payable and accrued liabilities | \$ | 1,346 |
| Oil and gas sales payable | | 1,494 |
| Income tax payable | | 208 |
| Total current liabilities | | 3,048 |

Stockholders' equity:

| | | |
|-------------------------------------------------------------------------------------------|----|---------|
| Preferred stock, \$.10 par value; 10,000,000 shares authorized; none issued | | |
| Common stock, \$.01 par value; 100,000,000 shares authorized, 8,986,319 shares issued | | 90 |
| Additional paid-in capital | | 22,207 |
| Accumulated deficit | | (2,741) |
| | | 19,556 |
| | \$ | 22,604 |

See accompanying notes.

Consolidated Statement of Operations
(in thousands)

| | Years ended December 31, | |
|---------------------------------------------------------------------------------------------------|--------------------------|----------|
| | 2005 | 2004 |
| Revenue: | | |
| Gas | \$ 1,012 | \$ 822 |
| Oil | 90 | 83 |
| Interest | 544 | 167 |
| | 1,646 | 1,072 |
| Costs and expenses: | | |
| Lease operating | 227 | 149 |
| Delay rentals | 57 | 102 |
| Impairment – unproved properties | 183 | 144 |
| Equity loss in CELLC | 103 | |
| Depreciation, depletion and amortization | 43 | 42 |
| General and administrative | 612 | 852 |
| | 1,225 | 1,289 |
| Income (loss) from continuing operations before minority interest | 421 | (217) |
| Minority interest | (84) | 65 |
| Income (loss) from continuing operations before taxes | 337 | (152) |
| Income tax-current | (145) | |
| Income (loss) from continuing operations | 192 | (152) |
| Income (loss) from discontinued operations net of minority interest of \$(18) and \$592 | (30) | 1,380 |
| Gain on sale of discontinued operations, net of taxes of \$1,085 and minority interest of \$4,168 | | 8,642 |
| Net income | \$ 162 | \$ 9,870 |
| Net Income (loss) per share – basic | | |
| Continuing operations | \$.027 | \$ (.02) |
| Discontinued operations | (.004) | .19 |
| Gain on sale of discontinued operations | | 1.22 |
| Net earnings per share | \$.023 | \$ 1.39 |
| Weighted average shares outstanding-basic | 7,155 | 7,093 |

See accompanying notes.

Consolidated Statement of Cash Flows
(in thousands)

| | Years ended December 31, | |
|------------------------------------------------------------------------------------------------------|--------------------------|-----------|
| | 2005 | 2004 |
| Cash flows from operating activities: | | |
| Net income | \$ 162 | \$ 9,870 |
| Equity loss in CELLC | 103 | |
| Depreciation, depletion, and amortization | 43 | 721 |
| Minority interest | 66 | 4,695 |
| Impairment of undeveloped properties | 183 | 144 |
| Change in accounts receivable | (1,197) | 812 |
| Gain on sale of discontinued operations exclusive of \$1,705 of bonuses paid in connection with sale | | (15,600) |
| Change in payables and accrued liabilities | 1,235 | (623) |
| Income taxes payable | (92) | 300 |
| Key employee bonus plan | | (253) |
| Other | 10 | 90 |
| Net cash provided by operating activities | 513 | 156 |
| Cash flows from investing activities: | | |
| Proceeds from property sale (Cuyama)* | 3,538 | 18,110 |
| Investment in COALition | (326) | |
| Investment in Savoy | (4,205) | |
| Decrease in bonds | 252 | |
| Properties | (4,696) | (253) |
| Prospect sale | 1,616 | |
| Other assets | (35) | (100) |
| Net cash (used in) provided by investing activities | (3,856) | 17,757 |
| Cash flows from financing activities: | | |
| Repurchase of employee stock options | (407) | (1,305) |
| Distributions to limited partners | (8,081) | |
| Stock sale to Yorktown Energy VI, L.P. | 4,165 | |
| Net cash used in financing activities | (4,323) | (1,305) |
| Net (decrease) increase in cash and cash equivalents | (7,666) | 16,608 |
| Cash and cash equivalents, beginning of year | 19,927 | 3,319 |
| Cash and cash equivalents, end of year | \$ 12,261 | \$ 19,927 |
| Taxes paid | \$ 225 | \$ 785 |

* In 2004 we received a \$3,500,000 note receivable in connection with the sale of Cuyama, which was a non-cash investing activity.

See accompanying notes.

Notes to Consolidated Financial Statements

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Consolidation

The accompanying consolidated financial statements include the accounts of Hallador Petroleum Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated. We are engaged in the exploration, development, and production of oil and natural gas in the Rocky Mountain region. We also have a 32% equity interest in an oil and gas company which has operations in Michigan.

As discussed in Item 6. (MD&A), we have entered into significant related party transactions with the Yorktown group of companies. Yorktown and its affiliates currently own about 54% of our common stock and represents one of the five seats on our board.

In early January 2006, we signed a Letter of Intent with Sunrise Coal, LLC (Sunrise) in order to effect a reorganization/merger between Hallador and Sunrise, a private company not affiliated with the Yorktown group of companies. We are working on a formal agreement which we hope to execute sometime in the second quarter 2006. In late February 2006, we sold 3,181,816 shares for \$2.20 per share (about \$7 million) to our existing shareholders. The proceeds will provide working capital for the Sunrise transaction.

During the first quarter of 2006, we loaned Sunrise \$7 million in order for Sunrise to begin development of their second coal mine (the "Carlisle mine"). Their Howesville mine began producing coal in November 2005. Both mines are located in Indiana. During the second quarter of 2006, Sunrise expects to enter into a \$30 million line-of-credit with two Indiana banks, at which time our \$7 million will be repaid. We have agreed to guarantee this \$30 million line-of-credit.

We have concluded to deemphasize our oil and gas operations and concentrate our future efforts in the coal business.

About nine years ago, Yorktown Energy Partners II and affiliates (Yorktown) invested \$5,025,000 in Hallador Petroleum, LLP, a newly formed limited liability limited partnership, (the "Partnership"). We are the general partner and received a 70% interest in the partnership in return for contributing our net assets and Yorktown representing the limited partners, received a 30% interest for its \$5,025,000 cash contribution. During the third quarter of 2005, we purchased the limited partners interest in the Partnership, and for accounting purposes the Partnership no longer exists and, as a result, there is no longer a minority interest caption on our balance sheet. Prior to this transaction we, as general partner, consolidated the activity of the Partnership and presented the 30% limited partners' interest as a minority interest.

On August 10, 2004, we entered into an agreement with E&B Natural Resources Management Corporation (a private company) to sell all of our interest in the South Cuyama field and adjacent exploration areas, all located in Santa Barbara County, California, for \$23 million; consisting of \$19.5 million in cash and an interest bearing (3.5%) note of \$3.5 million due on September 30, 2005, which was paid. Closing occurred on September 30, 2004 and we recorded a pre-tax gain of about \$14 million. Results from the South Cuyama field have been presented as discontinued operations in the accompanying Consolidated Statement of Operations; revenue and expenses before the minority interest were about \$7 million and \$5 million, respectively for 2004.

Due to the sale, our board of directors and the Executive Committee of the Partnership, voted to discontinue new partnership operations effective October 1, 2004. At that time, the Partnership's assets consisted of cash, the \$3.5 million note receivable, oil and gas properties in New Mexico and Texas, and other miscellaneous assets. On October 1, 2004, our board of directors and the Executive Committee of the Partnership, valued the oil and gas properties in New Mexico and Texas and the other miscellaneous assets at \$4 million. On May 6, 2005 we made a cash distribution of about \$5.2 million to the limited partners. During the third quarter 2005, we purchased the limited partners' interest in the Partnership for about \$1.2 million and made a final cash distribution to the limited partners of \$1.6 million. After these transactions, about \$1.7 million remained in the minority interest account and was recorded as a reduction in our accumulated deficit account.

In late March 2005, we invested \$325,000 for a 29% interest in a newly formed entity called COALition Energy, LLC (CELLC) to pursue coal opportunities in the United States. Some of our officers and directors also invested in CELLC.

Oil and Gas Properties

We account for our oil and gas activities using the successful efforts method of accounting. Under the successful efforts method, the costs of successful wells, development dry holes and productive leases are capitalized and amortized on a units-of-production basis over the remaining life of the related reserves. Exploratory dry hole costs and other exploratory costs, including geological and geophysical costs, and delay rentals are expensed as incurred. Cost centers for amortization purposes are determined on a field-by-field basis. Unproved properties with significant acquisition costs are periodically assessed for impairment in value, with any impairment charged to expense.

Prior to 2003, the estimated costs of plugging and abandoning wells were accrued using the units-of-production method and were considered in determining DD&A expense. However, in 2003 we adopted SFAS 143, Accounting for Asset Retirement Obligations. Under this standard, we record the fair value of the future abandonment as capitalized abandonment costs in Oil and Gas properties with an offsetting abandonment liability. The adoption of this method was not significant to our continuing operations. The capitalized abandonment costs are amortized with other property costs using the units-of-production method.

The carrying value of each field is assessed for impairment on a quarterly basis. If estimated future undiscounted net revenues are less than the recorded amounts, an impairment charge is recorded based on the estimated fair value of the field.

Statement of Cash Flows

Cash equivalents include investments, which includes mutual funds, with maturities when purchased of three months or less.

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Income Taxes

Income taxes are provided based on the liability method of accounting pursuant to SFAS 109, Accounting for Income Taxes. The provision for income taxes is based on pretax financial taxable income. Deferred tax assets and liabilities are recognized for the future expected tax consequences of temporary differences between income tax and financial reporting and principally relate to differences in the tax basis of assets and liabilities and their reported amounts, using enacted tax rates in effect for the year in which differences are expected to reverse. If it is more likely than not that some portion or all of a deferred tax asset will not be realized, a valuation allowance is recognized.

Earnings per Share

We follow the provisions of SFAS 128, Earnings Per Share. Basic earnings per share are computed based on the weighted average number of common shares outstanding. Diluted earnings per share are computed based on the weighted average number of common shares outstanding adjusted for the incremental shares attributed to outstanding stock options.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual amounts could differ from those estimates.

Revenue Recognition

We recognize oil and natural gas revenue from our interest in producing wells as natural gas and oil is produced and sold from those wells using the entitlement method.

Concentration of Credit Risk

Our revenues are derived principally from uncollateralized sales to two customers in the oil and gas industry. The concentration of credit risk in a single industry affects our overall exposure to credit risk because customers may be similarly affected by changes in economic and other conditions.

Stock Based Compensation

On April 15, 2005, we issued 750,000 ten-year options to employees at an exercise price of \$2.25. The exercise price was based on the sales price of a March 2005 private stock transaction between one of our shareholders and a third party. These options vest at 1/3 per year over the next three years. There are no more options available for issuance.

As allowed in SFAS 123, Accounting for Stock-Based Compensation, we continue to apply APB 25, Accounting for Stock Issued to Employees, and related interpretations in recording compensation related to our plan. Had compensation costs for the plan been determined consistent with SFAS 123, we would have estimated the fair value of the option grant using the Black-Scholes option-pricing model, using the following assumptions for the 2005 grants: (i) risk free interest rate of 4.24%; (ii) expected life of 10 years; (iii) expected volatility of 120%; (iv) expected default rate of 5%, and (v) no dividend yield. The average fair value of options granted during 2005 was \$2.15. Pro forma loss for the year ended December 31, 2005 would have been \$183,000 or \$(0.03) per share. Pro forma results for 2004 were immaterial.

No grants were issued during 2004.

On October 8, 2004 we purchased back 749,723 outstanding employee stock options at a price equal to \$2.80 per share minus the exercise price of each option for a total amount of \$1,305,000.

Changes in Stockholders' Equity

| | 000's |
|---------------------------------------------|-----------|
| Stockholders' Equity December 31, 2004 | \$ 13,507 |
| Proceeds from stock sale (1,893,169 shares) | 4,165 |
| Minority interest balance | 1,722 |
| Net income | 162 |
| Stockholders' Equity December 31, 2005 | \$ 19,556 |

Net income was the only change in stockholders' equity during 2004.

New Accounting Pronouncements

In December 2004, the FASB issued SFAS 123(R) that requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. That cost will be measured based on the fair value of the equity or liability instrument issued. SFAS 123(R) covers a wide range of share-based awards, stock appreciation rights, and employee stock purchase plans. SFAS 123(R) replaces SFAS 123, "Accounting for Stock-Based Compensation," and supersedes APB Opinion 25, "Accounting for Stock Issued to Employees." We will be required to apply SFAS 123(R) in the first quarter 2006, and will use the modified prospective method of adoption. We had \$1,035,000 of unvested compensation related to outstanding stock options and estimate having to expense \$115,000 during the first quarter of 2006.

None of the other FASB pronouncements issued during the last two years had, or will have, any effect on us.

(2) INCOME TAXES (in thousands)

The provision for income taxes is comprised of the following:

| | 2005 | 2004 |
|-----------|--------|----------|
| Current : | | |
| Federal | \$ 415 | \$ 265 |
| State | 189 | 361 |
| | 604 | 626 |
| Deferred: | | |
| Federal | (297) | 297 |
| State | (162) | 162 |
| | (459) | 459 |
| | \$ 145 | \$ 1,085 |

The net deferred tax asset at December 31, 2005 was not material.

Our income tax is different than the expected amount computed using the applicable federal statutory income tax rate of 35% and a California state tax rate of 8.84%. The reasons for and effects of such differences are as follows:

| | 2005 | 2004 |
|---------------------------------------------------|--------|----------|
| Expected amount | \$ 115 | \$ 4,864 |
| Utilization of tax net operating losses | -- | (2,174) |
| Utilization of statutory depletion carry forwards | -- | (974) |
| State income taxes, net of federal benefit | 16 | (340) |
| Change in valuation allowance and other | 14 | (291) |
| | \$ 145 | \$ 1,085 |

At December 31, 2005, we had no federal or state net operating loss, alternative minimum tax or statutory depletion carry forwards as all amounts were utilized during the current fiscal year.

(3) STOCK OPTIONS AND BONUS PLANS**Stock Option Plan**

On October 8, 2004, we purchased back 749,723 outstanding employee stock options at a price equal to \$2.80 per share minus the exercise price of each option for a total amount of \$1,305,000. The options were cancelled and available for reissuance. The \$1,305,000 was expensed during 2004. At December 31, 2004 there were no options outstanding. All options were granted at fair value.

In April 2005, we issued 750,000 options at an exercise price of \$2.25 based on a March 2005 private transaction between one of our shareholders and a third party. These options vest at 1/3 per year for the next three years and expire in April 2015. There are no more options available for issuance.

Options to purchase up to 3% of the partnership interest in Hallador Petroleum, LLP were issued in 1997 and 1998. As of December 31, 2004, 2.692% were outstanding and exercisable. The exercise price for these options was based on the fair market value on the date of grant. On January 8, 2005 we purchased back all of these outstanding options for a total of \$407,000, which was accrued for as of December 31, 2004.

(4) MAJOR CUSTOMERS

During 2005 and 2004, the San Juan Basin's gas and NGL production was purchased by Coral Energy Resources, LP and Williams Energy Services.

(5) EQUITY INVESTMENT IN SAVOY

In August 2005, we began negotiations to purchase from Yorktown Energy Partners II, LP its 32% interest in Savoy Energy LLP, a private company engaged in the oil and gas business primarily in the State of Michigan. A purchase price of \$4.1 million was agreed upon and closing occurred on December 31, 2005. On December 20, 2005 we sold about 1,893,000 shares of our common stock to Yorktown Energy Partners VI, L.P. at \$2.20 per share (about \$4.1 million). We will account for our interest in Savoy using the equity method of accounting.

Below (in thousands) are: (i) a condensed balance sheet at December 31, 2005, and (ii) a condensed statement of operations for the year ended December 31, 2005.

Condensed Balance Sheet

| | | |
|-------------------|----|--------|
| Current assets | \$ | 12,393 |
| PP&E, net | | 8,306 |
| | \$ | 20,699 |
| Total liabilities | \$ | 5,450 |
| Partners capital | | 15,249 |
| | \$ | 20,699 |

Condensed Statement Of Operations

| | | |
|--------------|----|---------|
| Revenue | \$ | 6,038 |
| Gain on sale | | 3,133 |
| | | 9,171 |
| Expenses | | (4,364) |
| Net income | \$ | 4,807 |

No equity income was recorded as closing on occurred on December 31, 2005.

Any difference between the purchase price and our pro rata share of the equity of Savoy will be amortized based on Savoy's units of production rate.

(6) RESERVE DATA (UNAUDITED)

Our reserve estimates for the years ended December 31, 2005 and 2004 were prepared by a sole-proprietor consulting petroleum engineer based on data we supplied. Savoy's reserve estimates were prepared by Netherland, Sewell & Associates. Be cautious that there are many uncertainties inherent in estimating proved reserve quantities and in projecting future production rates.

Proved reserves are the estimated quantities of oil and natural gas which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions. Proved developed reserves are those reserves expected to be recovered through existing wells with existing equipment and operating methods.

Analysis of Changes in Proved Developed Reserves *

(in thousands)

| | Oil (BBLs) | Gas (MCF) |
|---------------------------------------------|---------------|--------------|
| Balance at December 31, 2003 | 1,557 | 2,384 |
| Revisions of previous estimates | -- | (266) |
| Discoveries | -- | 141 |
| Production | (162) | (280) |
| Cuyama sale | (1,392) | (546) |
| Balance at December 31, 2004 | 3 | 1,433 |
| Revisions of previous estimates | (1) | (41) |
| Discoveries | -- | 112 |
| Production | (2) | (104) |
| Balance at December 31, 2005 ⁽¹⁾ | 0 | 1,400 |

*We have no significant proved undeveloped reserves.

Equity interest (32%) in Savoy's Reserves:

| | | |
|--------------------|----|-----|
| Proved developed | 22 | 634 |
| Proved undeveloped | 43 | 712 |

⁽¹⁾ Our oil reserves are not material.

The following table (in thousands) sets forth a standardized measure of the discounted future net cash flows attributable to our proved developed reserves (hereinafter referred to as "SMOG"). Future cash inflows were computed using December 31, 2005 and 2004 gas prices of \$8.69 and \$6.06, respectively. Future production costs represent the estimated future expenditures to be incurred in producing the reserves, assuming continuation of economic conditions existing at year-end. Discounting the annual net cash inflows at 10% illustrates the impact of timing on these future cash inflows.

| | 2005 | 2004 |
|--------------------------------------------------------------------------------------|-----------|----------|
| Future gas revenue | \$ 12,350 | \$ 8,200 |
| Future cash outflows – production and abandonment costs | (3,600) | (2,800) |
| Future income taxes | (3,500) | (2,100) |
| Future net cash flows | 5,250 | 3,300 |
| 10% discount factor | (2,450) | (1,500) |
| SMOG | \$ 2,800 | \$ 1,800 |
| Equity interest (32%) in Savoy (About 50% relates to proved undeveloped reserves) | \$ 4,400 | |

The following table (in thousands) summarizes the principal factors comprising the changes in SMOG:

| | 2005 | 2004 |
|-----------------------------------------------|----------|-----------|
| SMOG, beginning of year | \$ 1,800 | \$ 11,500 |
| Sales of oil and gas, net of production costs | (875) | (3,600) |
| Net changes in prices and production costs | 2,160 | (350) |
| Revisions | (165) | (300) |
| Discoveries | 450 | 100 |
| Change in income taxes | (750) | (1,200) |
| Accretion of discount | 180 | 1,150 |
| Cuyama sale | -- | (5,500) |
| SMOG, end of year | \$ 2,800 | \$ 1,800 |

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

ITEM 8A. CONTROLS AND PROCEDURES

We maintain a system of disclosure controls and procedures that are designed for the purposes of ensuring that information required to be disclosed in our SEC reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our CEO as appropriate to allow timely decisions regarding required disclosure.

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our CEO of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, our CEO, who is also our CFO, concluded that our disclosure controls and procedures are effective for the purposes discussed above. There have been no changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation.

ITEM 8B. OTHER INFORMATION

None.

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PART III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT

CORTLANDT S. DIETLER, 84, has been one of our directors since November 1995. From April 1995 to October 1999 he was CEO of TransMontaigne Inc. and is currently Chairman of the Board. He also serves as a director of Forest Oil Corporation, Cimarex Energy Company and Nytis Exploration Company.

DAVID HARDIE, 55 is the Chairman of the Board and has served as a director since July 1989. He is the President of Hallador Investment Advisors Inc., which manages Hallador Equity Fund, Hallador Fixed Income Fund, Hallador Alternative Assets Fund and Hallador Balance Fund; he also is a General Partner of Hallador Venture Partners LLC, the General Partner of Hallador Venture Fund II & III. Mr. Hardie is and serves as a director and partner of other private entities that are owned by members of his family. Mr. Hardie is a graduate of California Polytechnic University, San Luis Obispo and Harvard Business School, OPM.

STEVEN HARDIE, 52 has been a director since 1994. He and David Hardie are brothers. For the last 22 years he has been an investor in common stock and private equity. He is the Vice-President of Hallador Investment Advisors, which manages Hallador Equity Fund, Hallador Fixed Income Fund, Hallador Alternative Assets Fund and Hallador Balance Fund. He also serves as a director and partner of other private entities that are owned by members of his family.

BRYAN H. LAWRENCE, 62, has been one of our directors since November 1995. He is a founder and senior manager of Yorktown Partners LLC that manages investment partnerships formerly affiliated with Dillon, Read & Co. Inc., an investment-banking firm (Dillon Read). He had been employed with Dillon, Read since 1966, serving most recently as a Managing Director until the merger of Dillon Read with SBC Warburg in September 1997. He also serves as a Director of TransMontaigne, Inc., Crosstex Energy, Inc. and Crosstex Energy, L.P. (each a United States public company), Winstar Resources Ltd. (a Canadian Public Company) and certain non-public companies in the energy industry in which Yorktown partnership holds equity interests including, PetroSantander Inc., Savoy Energy, L.P., Camden Resources, Inc., ESI Energy Services Inc., Ellora Energy Inc., Dernick Resources Inc., Cinco Natural Resources Corp., Approach Resources Inc., Peak Energy Resources Inc., Nytis Exploration Company, Compass Petroleum, Ltd and Momentum Energy Group. Mr. Lawrence is a graduate of Hamilton College and has a MBA from Columbia University.

VICTOR P. STABIO, 58 is our President, CEO, CFO and a director. He joined us in March 1991 as our President and CEO and has been active in the oil and gas business for the past 30 years.

We do not have an audit committee financial expert serving on our audit committee. We believe that the additional costs to recruit a financial expert exceed the benefits, if any.

Our Code of Ethics is filed as Exhibit 14 to this Form 10-KSB.

Section 16(a) Beneficial Ownership Reporting Compliance

Our CEO, Victor Stabio, was late on filing one of his Form 4s.

ITEM 10. EXECUTIVE COMPENSATION

SUMMARY COMPENSATION TABLE
Annual Compensation

| <u>Name and Principal Position</u> | <u>Year</u> | <u>Salary</u> | <u>Bonus</u> | <u>Other Annual Compensation</u> | <u>Stock Options</u> |
|------------------------------------|-------------|---------------|------------------------|----------------------------------|----------------------|
| Victor P. Stabio, CEO | 2005 | \$100,000 | \$ 3,846 | \$ 0 | 400,000 |
| | 2004 | 137,000 | 632,000 ⁽¹⁾ | 1,251,900 ⁽³⁾ | |
| | 2003 | 146,000 | 73,500 ⁽¹⁾ | 6,000 ⁽²⁾ | |

⁽¹⁾Relates to the Key Employee Bonus Plan.

⁽²⁾Our contribution to the 401(k) Plan.

⁽³⁾Includes the purchase of 545,000 stock options at a cost of \$1.80 per option or \$981,000 in October 2004 and \$265,000 for the options to purchase 1.75% of Hallador Petroleum, LLP paid in January 2005.

On April 15, 2005, we granted Mr. Stabio 400,000 ten-year options at an exercise price of \$2.25 per share. Such options represented 53% of all the options granted to employees that year.

At December 31, 2005, Mr Stabio had 400,000 unexercisable options and the in-the-money value was \$400,000. Mr. Stabio did not exercise any options during the year.

Equity Compensation Plan Information

In April 2005, we granted 750,000 options at an exercise price of \$2.25 per share to our employees of which 400,000 were issued to Mr. Stabio. As of December 31, 2005, there were 750,000 options outstanding and there were no options outstanding at December 31, 2004.

| Plan Category | Number of Securities to be issued upon exercise of outstanding options, warrants and rights (a) | Weighted-average exercise price of outstanding options, warrants and rights (b) | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c) |
|---------------|-------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------|
| | | | |

| | | | | | |
|--|---------|--|--------|---|--|
| | 750,000 | | \$2.25 | 0 | |
|--|---------|--|--------|---|--|

Equity compensation plans
approved by security holders

| | | | | | | | |
|------------------------------------------------------------|---|---|---|--|--|--|--|
| Equity compensation plans not approved by security holders | 0 | 0 | 0 | | | | |
| | | | | | | | |

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table is as of April 4, 2006.

| Name | No. Shares ⁽¹⁾ | % of Class ⁽¹⁾ |
|------------------------------------------------------------------------------------|----------------------------------|----------------------------------|
| David Hardie and Steven Hardie as Nominee for Hardie Family Members ⁽²⁾ | 3,573,341 | 29 |
| Victor P. Stabio ⁽⁶⁾ | 208,270 | 2 |
| Cortlandt S. Dietler ⁽³⁾ | 100,000 | 1 |
| Bryan H. Lawrence ⁽⁴⁾ | 6,607,166 | 54 |
| Lubar & Associates ⁽⁵⁾ | 823,276 | 7 |
| All directors and executive officer as a group | 10,488,777 | 86 |

(1)Based on total outstanding shares of 12,168,135. Beneficial ownership of certain shares has been, or is being, specifically disclaimed by certain directors in ownership reports filed with the SEC.

(2)The Hardie family business address is 3000 S Street, Suite 200, Sacramento, California, 95816.

(3)Mr. Dietler's address is P. O. Box 5660, Denver, Colorado 80217. All shares are held by Pinnacle Engine Company LLC, wholly owned by Mr. Dietler.

(4)Mr. Lawrence's address is 410 Park Avenue, 19th Floor, New York, NY 10022. Mr. Lawrence owns 50,000 shares directly, and the remainder is held by Yorktown Energy Partners VI, L.P., an affiliate.

(5)Lubar & Associates address is 700 North Water Street, Suite 1200, Milwaukee, WI 53202.

(6)Includes 133,333 options exercisable within sixty days of April 4, 2006.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

As discussed in Item 6. (MD&A), we have entered into significant related party transactions with the Yorktown group of companies. Yorktown and its affiliates currently own about 54% of our common stock and represents one of the five seats on our board.

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ITEM 13. EXHIBITS

(a) Exhibits

- 3.1 Restated Articles of Incorporation of Kimbark Oil and Gas Company, effective September 24, 1987 ⁽¹⁾
 - 3.2 Articles of Amendment to Restated Articles of Incorporation of Kimbark Oil & Gas Company, effective December 14, 1989, to effect change of name to Hallador Petroleum Company and to change the par value and number of authorized shares of common stock ⁽¹⁾
 - 3.3 Amendment to Articles of Incorporation dated December 31, 1990 to effect the one-for-ten reverse stock split ⁽²⁾
 - 3.4 By-laws of Hallador Petroleum Company, effective November 9, 1993 ⁽⁴⁾
 - 10.1 Composite Agreement and Plan of Merger dated as of July 17, 1989, as amended as of August 24, 1989, among Kimbark Oil & Gas Company, KOG Acquisition, Inc., Hallador Exploration Company and Harco Investors, with Exhibits A, B, C and D ⁽¹⁾
 - 10.2 Hallador Petroleum Company 1993 Stock Option Plan ^{*(3)}
 - 10.3 Hallador Petroleum Company Key Employee Bonus Compensation Plan ^{*(3)}
 - 10.4 First Amendment to the 1993 Stock Option Plan ^{*(6)}
 - 10.5 First Amendment to Key Employee Bonus Compensation Plan ^{*(6)}
 - 10.6 Stock Purchase Agreement with Yorktown dated November 15, 1995 ⁽⁶⁾
 - 10.7 Second Amendment to Key Employee Bonus Compensation Plan ^{*(7)}
 - 10.8 Hallador Petroleum, LLP Agreement ⁽⁹⁾
 - 10.9 Hallador Petroleum, LLP Stock Option Agreement ^{*(9)}
 - 10.10 Purchase And Sale Agreement Among Hallador Petroleum Company, Hallador Production Company, Hallador Petroleum, LLP, Santa Barbara Partners, Trio Petroleum Inc., Cuyama Drilling and Production Company And South Cuyama Limited Partnership ("Sellers") And E&B Natural Resources Management Corporation and WRBD II, LP ("Buyers") ⁽¹¹⁾
 - 10.11 Subscription Agreement - by and between Hallador Petroleum Company and Yorktown Energy Partners VI, L.P, dated December 20, 2005.⁽¹²⁾
 - 10.12 Purchase and Sale Agreement dated December 31, 2005 between Hallador Petroleum Company, as Purchase and Yorktown Energy Partners II, L.P., as Seller relating to the purchase and sale of limited partnership interests in Savoy Energy Limited Partnership ⁽¹³⁾
 - 10.13 Letter of Intent dated January 5, 2006 between Hallador Petroleum Company and Sunrise Coal, LLC ⁽¹⁴⁾
 - 10.14 Subscription Agreement - by and between Hallador Petroleum Company and Yorktown Energy Partners VI, L.P., et al dated February 22, 2006. ⁽¹⁵⁾
 - 10.15 Subscription Agreement - by and between Hallador Petroleum Company and Hallador Alternative Assets Fund LLC dated February 14, 2006. ⁽¹⁶⁾
 - 10.16 Subscription Agreement - by and between Hallador Petroleum Company and Tecovas Partners V LP dated February 14, 2006. ⁽¹⁶⁾
 - 10.17 Subscription Agreement - by and between Hallador Petroleum Company and Lubar Equity Fund LLC dated February 14, 2006. ⁽¹⁶⁾
 - 10.18 Subscription Agreement - by and between Hallador Petroleum Company and Murchison Capital Partners LP dated February 14, 2006. ⁽¹⁶⁾
 - 14. Code Of Ethics For Senior Financial Officers. ⁽¹⁶⁾
 - 21.1 List of Subsidiaries ⁽²⁾
 - 31 SOX 302 Certification ⁽¹⁶⁾
 - 32 SOX 906 Certification ⁽¹⁶⁾
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- (1) Incorporated by reference (IBR) to the 1989 Form 10-K. (9) IBR to the 1997 Form 10-KSB.
 (2) IBR to the 1990 Form 10-K. (10) Not used.
 (3) IBR to the 1992 Form 10-KSB. (11) IBR to June 30, 2004 Form 10-QSB.
 (4) IBR to the 1993 Form 10-KSB. (12) IBR to Form 8-K dated December 31, 2005
 (5) Not used. (13) IBR to Form 8-K dated January 3, 2006
 (6) IBR to the 1995 Form 10-KSB. (14) IBR to Form 8-K dated January 6, 2006
 (7) IBR to the September 30, 1996 Form 10-QSB. (15) IBR to Form 8-K dated February 27, 2006
 (8) Not used. (16) Filed herewith.
 * Management contracts or compensatory plans.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The fees incurred for 2005 and 2004 were:

| | 2005 | 2004 |
|--------------------|-----------|-----------|
| Audit Fees | \$ 64,500 | \$ 56,000 |
| Audit-related fees | | |
| Tax fees | 15,000 | 31,000 |
| All other fees | | |
| Total fees | \$ 79,500 | \$ 87,000 |

Pre-approval Policy

In 2003 the Audit Committee adopted a formal policy concerning approval of audit and non-audit services to be provided by Ehrhardt Keefe Steiner & Hottman PC (EKSH). The policy requires that all services EKSH provides to us be pre-approved by the Committee. The Committee approved all services provided by EKSH during 2005 and 2004.

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on our behalf by the undersigned, thereunto duly authorized.

HALLADOR PETROLEUM COMPANY

Dated: April 14, 2006

BY:/S/ VICTOR P. STABIO
VICTOR P. STABIO, CEO

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| | | |
|------------------------------------------|----------------------------|----------------|
| /S/ DAVID HARDIE DAVID HARDIE | Chairman | April 14, 2006 |
| /S/ VICTOR P. STABIO VICTOR P. STABIO | CEO, CFO, CAO and Director | April 14, 2006 |
| /S/ BRYAN LAWRENCE BRYAN LAWRENCE | Director | April 14, 2006 |

