US ENERGY CORP
Form 10-Q
November 08, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x Quarterly report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarter ended September 30, 2010 or

o Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from ___________ to ____________

Commission File Number: 0-6814

U.S. ENERGY CORP.
(Exact name of registrant as specified in its charter)

Wyoming (State or other jurisdiction of incorporation or organization)	83-0205516 (I.R.S. Employer Identification No.)
877 North 8th West, Riverton, WY (Address of principal executive offices)	82501 (Zip Code)
Registrant's telephone number, including area code:	(307) 856-9271

Not Applicable
(Former name, address and fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to rule 405 of Regulations S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES o NO o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of “large accelerated filer,” “accelerated filer” and ‘smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer o
Non-accelerated filer x (Do not check if a smaller reporting company) Smaller reporting company o

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

At November 5, 2010, there were issued and outstanding 26,981,263 shares of the Company’s common stock, $.01 par value.

U.S. ENERGY CORP. and SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

U.S. ENERGY CORP.
CONDENSED CONSOLIDATED BALANCE SHEETS
ASSETS
(Unaudited)
(In thousands)

	September 30, 2010	December 31, 2009
CURRENT ASSETS:		
Cash and cash equivalents	$ 10,414	$ 33,403
Marketable securities		
Held to maturity - treasuries	29,242	22,059
Available for sale securities	1,110	1,178
Accounts receivable		
Trade	3,942	3,882
Reimbursable project costs	2	2
Income taxes	353	353
Other current assets	1,203	1,223
Total current assets	46,266	62,100
INVESTMENT	2,910	2,958
PROPERTIES AND EQUIPMENT:		
Oil & gas properties under full cost method, net	43,831	26,002
Undeveloped mining claims	22,003	21,969
Commercial real estate, net	22,512	23,200
Property, plant and equipment, net	9,540	9,301
Net properties and equipment	97,886	80,472
OTHER ASSETS	1,740	1,193
Total assets	$ 148,802	$ 146,723

The accompanying notes are an integral part of these statements.

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U.S. ENERGY CORP.
CONDENSED CONSOLIDATED BALANCE SHEETS
LIABILITIES AND SHAREHOLDERS' EQUITY
(Unaudited)
(In thousands, except shares)

	September 30, 2010	December 31, 2009
CURRENT LIABILITIES:		
Accounts payable	$4,442	$6,500
Accrued compensation	1,515	1,748
Commodity risk management liability	586	--
Current portion of long-term debt	200	200
Other current liabilities	711	224
Total current liabilities	7,454	8,672
LONG-TERM DEBT, net of current portion	600	600
DEFERRED TAX LIABILITY	7,685	7,345
ASSET RETIREMENT OBLIGATIONS	293	211
OTHER ACCRUED LIABILITIES	838	762
SHAREHOLDERS' EQUITY:		
Common stock, $.01 par value; unlimited shares authorized; 26,856,290 and 26,418,713 shares issued, respectively	269	264
Additional paid-in capital	120,646	118,998
Accumulated surplus	10,647	9,485
Unrealized gain on marketable securities	370	386
Total shareholders' equity	131,932	129,133
Total liabilities and shareholders' equity	$148,802	$146,723

The accompanying notes are an integral part of these statements.

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U.S. ENERGY CORP.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In thousands except per share data)

	Three months ended September 30, 2010	Three months ended September 30, 2009	Nine months ended September 30, 2010	Nine months ended September 30, 2009
REVENUES:				
Oil and gas	$6,303	$691	$20,230	$2,119
Unrealized (loss) on				
risk management activities	(586)	--	(586)	--
Real estate	646	686	1,893	2,165
	6,363	1,377	21,537	4,284
OPERATING EXPENSES:				
Oil and gas	4,399	544	11,678	2,143
Impairment of oil and gas properties	--	405	--	1,468
Real estate	562	507	1,717	1,517
Water treatment plant	347	379	1,155	1,398
Mineral holding costs	9	--	61	--
General and administrative	1,920	1,838	6,755	5,675
	7,237	3,673	21,366	12,201
OPERATING INCOME (LOSS):	(874)	(2,296)	171	(7,917)
Other income and (expenses)				
Gain/(loss) on sale of assets	--	(46)	115	(41)
Equity gain/(loss) in				
unconsolidated investment	(52)	(339)	1,090	(505)
Gain on sale of marketable securities	26	--	34	--
Miscellaneous income	60	5	61	14
Interest income	30	88	91	264
Interest expense	(16)	(20)	(51)	(78)
	48	(312)	1,340	(346)
INCOME (LOSS) BEFORE INCOME TAX:	(826)	(2,608)	1,511	(8,263)
Income taxes:				
Current (provision for) benefit from	--	(3)	--	210
Deferred (provision for) benefit from	591	867	(349)	1,077
	591	864	(349)	1,287
NET INCOME (LOSS)	$(235)	$(1,744)	$1,162	$(6,976)
NET INCOME (LOSS) PER SHARE				
Basic	$(0.01)	$(0.09)	$0.04	$(0.33)

Diluted	$(0.01)	$(0.09)	$0.04	$(0.33)
Weighted average shares outstanding				
Basic	26,855,513	21,288,841	26,693,710	21,416,869
Diluted	26,855,513	21,288,841	27,743,396	21,416,869

The accompanying notes are an integral part of these statements.

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U.S. ENERGY CORP.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

	Nine months ended September 30, 2010	Nine months ended September 30, 2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$1,162	$(6,976)
Adjustments to reconcile net income (loss) to net cash provided by operations		
Depreciation, depletion and amortization	8,763	2,918
Change in fair value of commodity price risk management activities, net	586	--
Accretion of discount on treasury investment	(61)	(160)
Impairment of oil and gas properties	--	1,468
Gain on sale of marketable securities	(34)	--
Equity (gain)/loss from Standard Steam	(1,090)	505
Change in deferred income taxes	349	(1,077)
(Gain)/loss on sale of assets	(115)	41
Noncash compensation	1,101	1,283
Noncash services	48	50
Net changes in assets and liabilities	1,546	4,802
NET CASH PROVIDED BY OPERATING ACTIVITIES	12,255	2,854
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition and development of oil and gas properties	$(29,013)	$(9,078)
Net (investment in) redemption of treasury investments	(7,122)	24,088
Net distribution from (investment in) Standard Steam	1,138	(877)
Acquisition and development of mining properties	(34)	(10)
Mining property option payment	--	1,000
Development of real estate	--	(91)
Acquisition of property and equipment	(704)	(249)
Proceeds from sale of property and equipment	118	5
Proceeds from sale of marketable securities	77	--
Net change in restricted investments	(207)	4,682
NET CASH (USED IN) PROVIDED BY INVESTING ACTIVITIES	(35,747)	19,470

The accompanying notes are an integral part of these statements.

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U.S. ENERGY CORP.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

	Nine months ended September 30, 2010	2009
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance of common stock, net	$503	$--
Repayments of debt	--	(17,688)
Stock buyback program	--	(1,399)
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	503	(19,087)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(22,989)	3,237
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	33,403	8,434
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$10,414	$11,671
SUPPLEMENTAL DISCLOSURES:		
Income tax received	$--	$(5,753)
Interest paid	$15	$34
NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Unrealized gain	$370	$143
Acquisition and development of oil and gas properties through accounts payable	$1,894	$--
Acquisition and development of oil and gas through asset retirement obligation	$70	$--

The accompanying notes are an integral part of these statements.

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U.S. ENERGY CORP.

Notes to Condensed Consolidated Financial Statements (Unaudited)

1) Basis of Presentation

The accompanying unaudited condensed financial statements for the periods ended September 30, 2010 and September 30, 2009 have been prepared by U.S. Energy Corp. ("USE" or the "Company") in accordance with generally accepted accounting principles ("GAAP") in the United States of America. The financial statements at September 30, 2010 include the Company's wholly owned subsidiary Energy One LLC ("Energy One") which owns the majority of the Company's oil and gas assets. The Condensed Balance Sheet at December 31, 2009 was derived from audited financial statements. In the opinion of the Company, the accompanying condensed financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of the Company for the reported periods. Entities in which the Company holds at least 20% ownership or in which there are other indicators of significant influence are generally accounted for by the equity method, whereby the Company records its proportionate share of the entities' results of operations. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted. The unaudited condensed financial statements should be read in conjunction with the Company's December 31, 2009 Annual Report on Form 10-K. Subsequent events have been evaluated for financial reporting purposes through the date of the filing of this Form 10-Q. See Note 12.

2) Summary of Significant Accounting Policies

For detailed descriptions of our significant accounting policies, please see Form 10-K for the year ended December 31, 2009 (Note B pages 84 to 92).

We follow accounting standards set by the Financial Accounting Standards Board, commonly referred to as the "FASB." The FASB sets generally accepted accounting principles (GAAP) that we follow to ensure we consistently report our financial condition, results of operations, and cash flows.

The FASB recognized the complexity of its standard-setting process and embarked on a revised process in 2004 that culminated in the release on July 1, 2009, of the FASB Accounting Standards Codification, sometimes referred to as the Codification or ASC. The Codification does not change how the Company accounts for its transactions or the nature of related disclosures made. However, when referring to guidance issued by the FASB, the Company refers to topics in the ASC. The above change was made effective by the FASB for periods ending on or after September 15, 2009.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates include oil and gas reserves used for depletion and impairment considerations and the cost of future asset retirement obligations. Due to inherent uncertainties, including the future prices of oil and gas, these estimates could change in the near term and such changes could be material.

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U.S. ENERGY CORP.

Notes to Condensed Consolidated Financial Statements (Unaudited)
(Continued)

Oil and Gas Properties

USE follows the full cost method in accounting for its oil and gas properties. Under the full cost method, all costs associated with the acquisition, exploration and development of oil and gas properties are capitalized and accumulated in a country-wide cost center. This includes any internal costs that are directly related to development and exploration activities, but does not include any costs related to production, general corporate overhead or similar activities. Proceeds received from property disposals are credited against accumulated cost except when the sale represents a significant disposal of reserves, in which case a gain or loss is recognized. The sum of net capitalized costs and estimated future development and dismantlement costs for each cost center is depleted on the equivalent unit-of-production method, based on proved oil and gas reserves. Excluded from amounts subject to depletion are costs associated with unproved properties.

Under the full cost method, net capitalized costs are limited to the lower of unamortized cost reduced by the related net deferred tax liability and asset retirement obligations or the cost center ceiling. The cost center ceiling is defined as the sum of (i) estimated future net revenue, discounted at 10% per annum, from proved reserves, based on unescalated average prices per barrel of oil and per MMbtu of natural gas at the first day of each month in the 12-month period prior to the end of the reporting period and costs, adjusted for contract provisions, financial derivatives that hedge our oil and gas revenue and asset retirement obligations, (ii) the cost of properties not being amortized, and (iii) the lower of cost or market value of unproved properties included in the cost being amortized, reduced by the (iv) income tax effects related to differences between the book and tax basis of the natural gas and crude oil properties. If the net book value reduced by the related net deferred income tax liability and asset retirement obligations exceeds the cost center ceiling limitation, a non-cash impairment charge is required in the period in which the impairment occurs. At September 30, 2010, the book value of our oil and gas properties did not exceed the cost center ceiling.

Derivative Instruments

The Company uses derivative instruments, typically fixed-rate swaps and costless collars to manage price risk underlying its oil and gas production. The Company may also use puts, calls and basis swaps in the future. All derivative instruments are recorded in the consolidated balance sheets at fair value. The Company offsets fair value amounts recognized for derivative instruments executed with the same counterparty. Although the Company does not designate any of its derivative instruments as a cash flow hedge, such derivative instruments provide an economic hedge of our exposure to commodity price risk associated with forecasted future oil and gas production. These contracts are accounted for using the mark-to-market accounting method and accordingly, the Company recognizes all unrealized and realized gains and losses related to these contracts currently in earnings and are classified as gain (loss) on derivative instruments, net in our consolidated statements of operations.

The Company's Board of Directors sets all risk management policies and reviews the status and results of derivative activities, including volumes, types of instruments and counterparties on a quarterly basis. These policies require that derivative instruments be executed only by the President or Chief Financial Officer after consultation and concurrence by the President, Chief Financial Officer and Chairman of the Board. The master contracts with approved counterparties identify the President and Chief Financial Officer as the only Company representatives authorized to execute trades. See Note 5, Commodity Price Risk Management, for further discussion.

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U.S. ENERGY CORP.

Notes to Condensed Consolidated Financial Statements (Unaudited)
(Continued)

Revenue Recognition

USE records natural gas and oil revenue under the sales method of accounting. Under the sales method, we recognize revenues based on the amount of oil or natural gas sold to purchasers, which may differ from the amounts to which we are entitled to based on our interest in the properties. Natural gas balancing obligations as of September 30, 2010 were not significant.

Revenues from real estate operations are reported on a gross revenue basis and are recorded at the time the service is provided.

Recent Accounting Pronouncements

As of September 30, 2010, there have been no recent accounting pronouncements currently relevant to USE in addition to those discussed on pages 90 to 92 of our Annual Report on Form 10-K for the year ended December 31, 2009. We continue to review current outstanding statements from the FASB and do not believe that any of those statements will have a material effect on our financial statements when adopted.

3) Properties and Equipment

Land, buildings, improvements, machinery and equipment are carried at cost. Depreciation of buildings, improvements, machinery and equipment is provided principally by the straight-line method over estimated useful lives ranging from 3 to 45 years.

Components of Property and Equipment as of September 30, 2010 and December 31, 2009 are as follows:

U.S. Energy Corp.
Components of Properties & Equipment

	(In thousands)	
	September 30, 2010	December 31, 2009
Oil & Gas properties		
Unproved	$ 2,795	$ 3,993
Wells in progress	2,534	1,367
Proved	50,083	24,595
	55,412	29,955
Less accumulated depreciation depletion and amortization	(11,581)	(3,953)
Net book value	43,831	26,002

Mining properties	22,003	21,969
Commercial real estate	24,622	24,600
Less Accumulated depreciation	(2,110)	(1,400)
Net book value	22,512	23,200
Building, land and equipment	14,621	14,196
Less accumulated depreciation	(5,081)	(4,895)
Net book value	9,540	9,301
Totals	$ 97,886	$ 80,472

U.S. ENERGY CORP.

Notes to Condensed Consolidated Financial Statements (Unaudited)
(Continued)

Oil and Gas Exploration Activities

We participate in oil and gas projects as a non-operating working interest owner and have active agreements with several oil and gas exploration and production companies. Our working interest varies by project, but typically ranges from approximately 5% to 65%. These projects may result in numerous wells being drilled over the next three to five years.

Williston Basin, North Dakota

From August 24, 2009 to September 30, 2010, we have drilled and completed 11 gross initial Bakken Formation wells (4.89 net) and 1 gross Three Forks formation well (0.17 net) under the Drilling Participation Agreement with Brigham Oil & Gas, L.P. ("Brigham") a Delaware limited partnership, wholly-owned by Brigham Exploration Company (a Delaware corporation). One gross initial Bakken formation well (0.20 net) and 2 infill Bakken formation wells (0.63 net) were in progress at September 30, 2010. Three additional gross initial wells (0.93 net) are expected to be drilled during the balance of 2010. Brigham operates all of the wells.

During the first nine months of 2010, USE completed 6 gross wells (2.08 net) with our percentage of the net costs of $14.1 million. Two gross wells (0.63 net) were drilled and awaiting completion at September 30, 2010 with net costs to us of $1.9 million. One additional gross well (0.20 net) was being drilled at September 30, 2010 with net costs to the Company of $538,000.

If the state of North Dakota allows three wells per formation in each spacing unit, the Company could ultimately drill 45 Bakken formation and 45 Three Forks formation wells for a total of 90 wells. The drilling of each well typically takes 30 days while the completion typically takes 21-28 days.

U.S. Gulf Coast

During the first nine months of 2010, we drilled 7 gross wells (0.94 net) in the U.S. Gulf Coast. One gross well (0.50 net) was successfully completed and is currently producing, 2 gross wells (0.15 net) were in progress at September 30, 2010, 1 gross well (0.05 net) was completed, but not producing and 3 gross wells (0.24 net) have been plugged and abandoned. Our net investment in these wells through September 30, 2010 was $7.6 million. See Note 12, Subsequent Events.

We are also actively pursuing the potential of acquiring additional exploration, development or production stage oil and gas properties or companies. To further this effort, we have engaged an investment banker to assist in finding, evaluating and if necessary, financing the potential acquisition of such assets.

Full cost pool capitalized costs are amortized over the life of production of proven properties. Capitalized costs at September 30, 2010 and December 31, 2009 which were not included in the amortized cost pool were $5.3 and $5.4 million, respectively. These costs consist of wells in progress, seismic costs that are being analyzed for potential drilling locations and land costs, all related to unproved properties. No capitalized costs related to unproved properties are included in the amortization base at September 30, 2010 and December 31, 2009. It is anticipated that these costs will be added to the full cost amortization pool in the next two years as properties are proved, drilled or abandoned.

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U.S. ENERGY CORP.

Notes to Condensed Consolidated Financial Statements (Unaudited)
(Continued)

Ceiling Test Analysis - We perform a quarterly ceiling test for each of our oil and gas cost centers, which in 2010, there was only one. The reserves used in the ceiling test and the ceiling test itself incorporate assumptions regarding pricing and discount rates over which management has no influence in the determination of present value. In arriving at the ceiling test for the quarter ended September 30, 2010, we used $77.34 per barrel for oil and $4.41 per MMbtu for natural gas (and adjusted for property specific gravity, quality, local markets and distance from markets) to compute the future cash flows of our producing properties. The discount factor used was 10%.

At September 30, 2010, the ceiling was in excess of the net capitalized costs as adjusted for related deferred income taxes and no impairment was required. Management will continue to review our unproved properties based on market conditions and other changes and if appropriate, unproved property amounts may be reclassified to the amortized base of properties within the full cost pool. During the nine months ended September 30, 2009, we recorded a $1.5 million impairment.

Wells in Progress - Wells in progress represent the costs associated with wells that have not reached total depth or have not been completed as of period end. They are classified as wells in progress and withheld from the depletion calculation. The costs for these wells are then transferred to proved property when the wells reach total depth and are cased and the costs become subject to depletion and the ceiling test calculation in future periods.

Mineral Properties

We capitalize all costs incidental to the acquisition of mineral properties. Mineral exploration costs are expensed as incurred. When exploration work indicates that a mineral property can be economically developed as a result of establishing proved and probable reserves, costs for the development of the mineral property as well as capital purchases and capital construction are capitalized and amortized using units of production over the estimated recoverable proved and probable reserves. Costs and expenses related to general corporate overhead are expensed as incurred. All capitalized costs are charged to operations if we subsequently determine that the property is not economical due to permanent decreases in market prices of commodities, excessive production costs or depletion of the mineral resource.

Mineral properties at September 30, 2010 and December 31, 2009 reflect capitalized costs associated with our Mount Emmons molybdenum property near Crested Butte, Colorado. We have entered into an agreement with Thompson Creek Metals Company USA ("TCM") to develop this property. TCM may earn up to a 75% interest in the project for the investment of $400 million.

Our carrying balance in the Mount Emmons property at September 30, 2010 and December 31, 2009 is as follows:

	(In thousands)
Costs associated with Mount Emmons	
at December 31, 2009	$ 21,969

Development costs during the nine months ended September 30, 2010		34
	$	22,003

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U.S. ENERGY CORP.

Notes to Condensed Consolidated Financial Statements (Unaudited)
(Continued)

Real Estate

We evaluate our long-lived assets, which consist of commercial real estate, for impairment when events or changes in circumstances indicate that the related carrying amount may not be recoverable. Impairment calculations are generally based on market appraisals. If estimated future cash flows, on an undiscounted basis, are less than the carrying amount of the related asset, an asset impairment is considered to exist. Changes in significant assumptions underlying future cash flow estimates may have a material effect on our financial position and results of operations. We do not obtain appraisals on an ongoing basis for the property. We however did obtain an appraisal in 2009. At September 30, 2010 and December 31, 2009, management determined that no impairment existed on our long-lived asset as the 2009 appraised value exceeded construction and carrying value, rental rates remained strong and costs remain within projected limits.

4) Asset Retirement Obligations

We account for our asset retirement obligations under FASB ASC 410-20, "Asset Retirement Obligations." We record the fair value of the reclamation liability on our inactive mining properties and our operating oil and gas properties as of the date that the liability is incurred. We review the liability each quarter and determine if a change in estimate is required as well as accrete the discounted liability on a quarterly basis for the future liability. Final determinations are made during the fourth quarter of each year. We deduct any actual funds expended for reclamation during the quarter in which it occurs.

The following is a reconciliation of the total liability for asset retirement obligations:

	(In thousands)	
	September 30, 2010	December 31, 2009
Beginning asset retirement obligation	$ 211	$ 144
Accretion of discount	12	12
Liabilities incurred	70	55
Ending asset retirement obligation	$ 293	$ 211
Mining properties	$ 136	$ 128
Oil & Gas Wells	157	83
Ending asset retirement obligation	$ 293	$ 211

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U.S. ENERGY CORP.

Notes to Condensed Consolidated Financial Statements (Unaudited)
(Continued)

5) Commodity Price Risk Management

Through our wholly-owned affiliate Energy One LLC ("Energy One"), we have entered into two commodity derivative contracts ("economic hedges") with BNP Paribas, a costless collar and a fixed price swap, as described below. U.S. Energy Corp. is a guarantor of Energy One under the economic hedges. The objective of utilizing the economic hedges is to reduce the effect of price changes on a portion of its future oil production, achieve more predictable cash flows in an environment of volatile oil and gas prices and to manage its exposure to commodity price risk. The use of these derivative instruments limits the downside risk of adverse price movements. However, there is a risk that such use may limit our ability to benefit from favorable price movements. Energy One may, from time to time, add incremental derivatives to hedge additional production, restructure existing derivative contracts or enter into new transactions to modify the terms of current contracts in order to realize the current value of the its existing positions.

Energy One's commodity derivative contracts as of September 30, 2010 are summarized below:

Settlement Period	Counterparty	Basis	Quantity (Bbl/d)	Strike Price
Crude Oil Costless Collars				
10/1/10 - 9/30/11	BNP Parabis	WTI	200	Put: $75.00
				Call: $83.25
Crude Oil Swap				
10/1/10 - 9/30/11	BNP Parabis	WTI	200	Fixed: $79.05

The following table details the fair value of the derivatives recorded in the applicable condensed consolidated balance sheet, by category:

Underlying Commodity	Location on Balance Sheet	Fair Value at September 30, 2010
Crude oil derivative contract	Current liability	$ 256,000
Crude oil derivative contract		330,000

Current liability	
	$ 586,000

Unrealized gains and losses resulting from derivatives are recorded at fair value on the condensed consolidated balance sheet and changes in fair value are recognized in the unrealized gain (loss) on risk management activities line on the condensed consolidated statement of operations. Realized gains and losses resulting from the contract settlement of derivatives will be recorded in the commodity price risk management activities line on the condensed consolidated statement of income. There were no realized gains or losses recorded for the nine months ending September 30, 2009.

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U.S. ENERGY CORP.

Notes to Condensed Consolidated Financial Statements (Unaudited)
(Continued)

6) Fair Value

We adopted Financial Accounting Standards Board Accounting Standards Codification Topic 820 “Fair Value Measurements and Disclosures” (FASB ASC 820) on January 1, 2008, as it relates to financial assets and liabilities. We adopted FASB ASC 820 on January 1, 2009, as it relates to nonfinancial assets and liabilities. FASB ASC 820 establishes a fair value hierarchy that prioritizes the inputs USE uses to measure fair value. The three levels of the fair value hierarchy defined by FASB ASC 820 are as follows:

- Level 1 — Unadjusted quoted prices are available in active markets for identical assets or liabilities.
- Level 2 — Pricing inputs, other than quoted prices within Level 1, which are either directly or indirectly observable.
- Level 3 — Pricing inputs that are unobservable requiring the Company to use valuation methodologies that result in management’s best estimate of fair value.

Our assessment of the significance of a particular input to the fair value measurement requires judgment and may affect the valuation of the nonfinancial assets and liabilities and their placement in the fair value hierarchy levels. As of September 30, 2010, we held $30.4 million of investments in government securities and marketable securities. The fair value of the investments is reflected on the balance sheet as detailed below. The fair value of our other accrued liabilities are determined using discounted cash flow methodologies based on inputs that are not readily available in public markets. The fair values of the other accrued liabilities that are reflected on the balance sheet are detailed below.

		(In thousands) Fair Value Measurements at September 30, 2010 Using		
Description	September 30, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities	$ 1,110	$ 1,110	$ --	$ --
Total assets	$ 1,110	$ 1,110	$ --	$ --
Commodity risk management	$ 586	$ --	$ 586	$ --

liability				
Other accrued liabilities	838	--	--	838
Total liabilitities	$ 1,424	$ --	$ 586	$ 838

The other accrued liabilities are the long term portion of the executive retirement program.

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U.S. ENERGY CORP.

Notes to Condensed Consolidated Financial Statements (Unaudited)
(Continued)

The following table summarizes, by major security type, the fair value and any unrealized gain of our investments. The unrealized gain is recorded on the condensed consolidated balance sheets as other comprehensive income, a component of shareholders' equity.

(In thousands)
September 30, 2010

Description of Securities	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized Gain	12 Months or Greater Fair Value	12 Months or Greater Unrealized Gain	Total Fair Value	Total Unrealized Gain
Available for sale securities	$ 1,110	$ 206	$ --	$ --	$ 1,110	$ 206
Total	$ 1,110	$ 206	$ --	$ --	$ 1,110	$ 206

Our other financial instruments include cash and cash equivalents, accounts receivable, accounts payable, other current liabilities and long-term debt. The carrying amount of cash and cash equivalents, accounts receivable, accounts payable and other current liabilities approximate fair value because of their immediate or short-term maturities. The carrying value of the long-term debt approximates its fair market value since interest rates have remained generally unchanged from the issuance of the long-term debt. The following is the estimated fair value and carrying value of our other financial instruments at each of these dates:

(In thousands)

Description	September 30, 2010 Carry Amount	Fair Value
Long-term debt	$ 800	$ 800

7) Long-term debt

At September 30, 2010, long term debt consists of debt related to the purchase of land which bears an interest rate of 6% per annum. The debt is due in four equal annual payments of $200,000, plus accrued interest. The next payment is due on January 2, 2011.

8) Shareholders' Equity

Common Stock

During the three and nine months ended September 30, 2010, USE issued 21,584 and 437,577 shares of common stock, respectively. These shares consist of (a) 60,000 shares issued to officers of the Company pursuant to the 2001 Stock Compensation Plan; (b) 236,367 shares issued as a result of warrants being exercised and (c) 141,210 shares as a result of the exercise of options by employees of the Company.

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U.S. ENERGY CORP.

Notes to Condensed Consolidated Financial Statements (Unaudited)
(Continued)

The following table details the changes in common stock during the nine months ended September 30, 2010:

(Amounts in thousands, except for share amounts)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital
Balance December 31, 2009	26,418,713	$ 264	$ 118,998
2001 stock compensation plan	60,000	1	337
Exercise of employee stock options	141,210	1	(201)
Exercise of stock warrants	236,367	3	700
Expense of employee options vesting	--	--	764
Stock options issued to outside directors	--	--	45
Expense of company warrants issued	--	--	3
Balance September 30, 2010	26,856,290	$ 269	$ 120,646

Stock Option Plans

The Board of Directors adopted, and the shareholders approved, the U.S. Energy Corp. 2001 Incentive Stock Option Plan (the "2001 ISOP") for the benefit of the Company's employees. The 2001 ISOP reserves for issuance shares of the Company’s common stock equal to 25% of the Company’s shares of common stock issued and outstanding at any time. The 2001 ISOP has a term of 10 years.

During the three and nine months ended September 30, 2010, we recognized $257,000 and $764,000, respectively, in compensation expense related to employee options. We will recognize an additional $1.2 million in expense over the remaining vesting life of the outstanding options of 1.2 years. We compute the fair values of options granted using the Black-Scholes pricing model. 141,210 shares of common stock were issued as a result of the exercise of 360,984 options held by officers and employees during the nine months ended September 30, 2010.

Warrants to Others

From time to time we issue stock purchase warrants to non-employees for services. During the nine months ended September 30, 2010, we issued 10,000 warrants to an independent director. The warrants were issued at the closing price of $5.04 on the date of grant, vest over a three year period and expire ten years from the date of grant. The options were valued under Black-Scholes using a risk free interest rate of 2.235%, expected life of 6 years and expected volatility of 63.79%. During the nine months ended September 30, 2010 we issued 236,367 shares of common stock as the result of the exercise of outstanding warrants.

During the three and nine months ended September 30, 2010, we recorded $18,000 and $48,000, respectively, in expense for warrants issued to third parties. We will recognize an additional $87,000 in expense over the vesting period of the outstanding warrants.

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U.S. ENERGY CORP.

Notes to Condensed Consolidated Financial Statements (Unaudited)
(Continued)

The following table represents the activity in employee stock options and non-employee stock purchase warrants for the nine months ended September 30, 2010:

	September 30, 2010			
	Employee Stock Options		Stock Purchase Warrants	
	Options	Weighted Average Exercise Price	Warrants	Weighted Average Exercise Price
Outstanding balance at December 31, 2009	3,711,114	$ 3.64	581,367	$