

ONRR Year In Review

Fiscal Year 2011 in Review

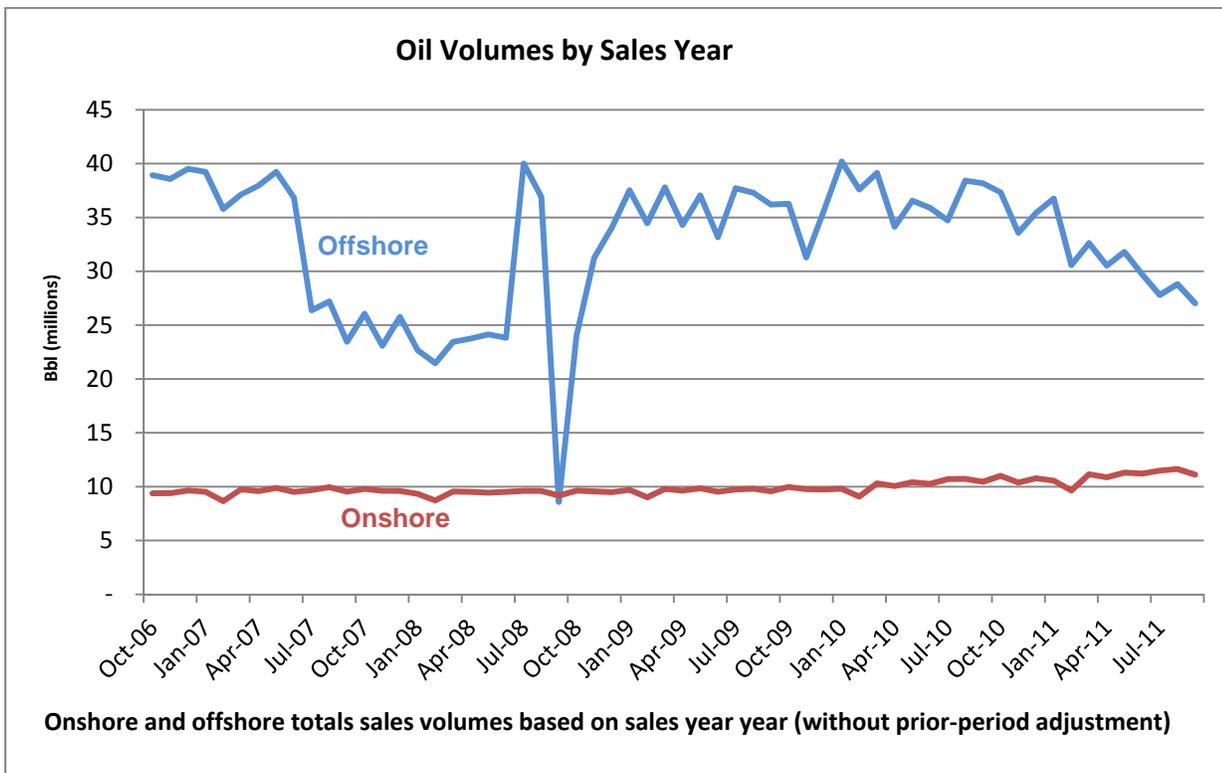
Overview:

Fiscal Year (FY) 2011, October 2010 through September 2011, saw a relatively stable year for the domestic oil and gas commodity markets. Factors that normally drive commodity instability such as economic changes, supply and demand fluctuations, financial market technical factors, and localized weather events were less volatile during FY 2011. Geopolitical risk, however, contributed pointedly to price volatility in the oil markets.

Crude oil prices continued to rise from the dramatic fall that occurred in FY 2009. New York Mercantile Exchange (NYMEX) West Texas Intermediate (WTI) values averaged \$92.88 per barrel in FY 2011, while trading in a range from \$79 to \$114 per barrel - a 20 percent increase from the FY 2010 average of \$77.30 per barrel. The price difference (basis) between the Gulf of Mexico (GOM) and onshore Federal oil production widened significantly in FY 2011 due primarily to increased production from onshore shale plays. This oversupply in the US Midcontinent combined with pipeline bottlenecks, put downward pressure on the WTI Cushing benchmark, pushing it to unprecedented discounts to other global benchmarks. WTI has been trading at a discount to Dated Brent (the European benchmark) since September 2010. As a majority of the waterborne crude coming into the GOM is tied to Dated Brent, GOM crude differentials have become tied to Brent, trading on average \$8 higher than WTI. Federal oil volumes subject to royalty payments were down about 8 percent from FY 2010 as sharp declines in GOM volumes offset gains in onshore oil production.

Natural gas prices declined slightly in FY 2011 with the average NYMEX price at Henry Hub of \$4.10 per MMBtu, a decrease of 9 percent from the FY 2010 average of \$4.49 per MMBtu. The latter half of FY 2011 showed a steady decline in gas prices as demand remained flat amid increasing supply from onshore shale formations. The price basis across the nation narrowed even more significantly in FY 2011 than in FY 2010 due to the declining price and infrastructure improvements. Increased Marcellus shale gas production has put further downward pressure on GOM and Rockies prices. Federal gas volumes subject to royalty payments declined by about 7 percent in FY 2011 as lower prices dampened drilling activity on Federal lands and the GOM continued its long-term decline.

Oil Volume Observations:

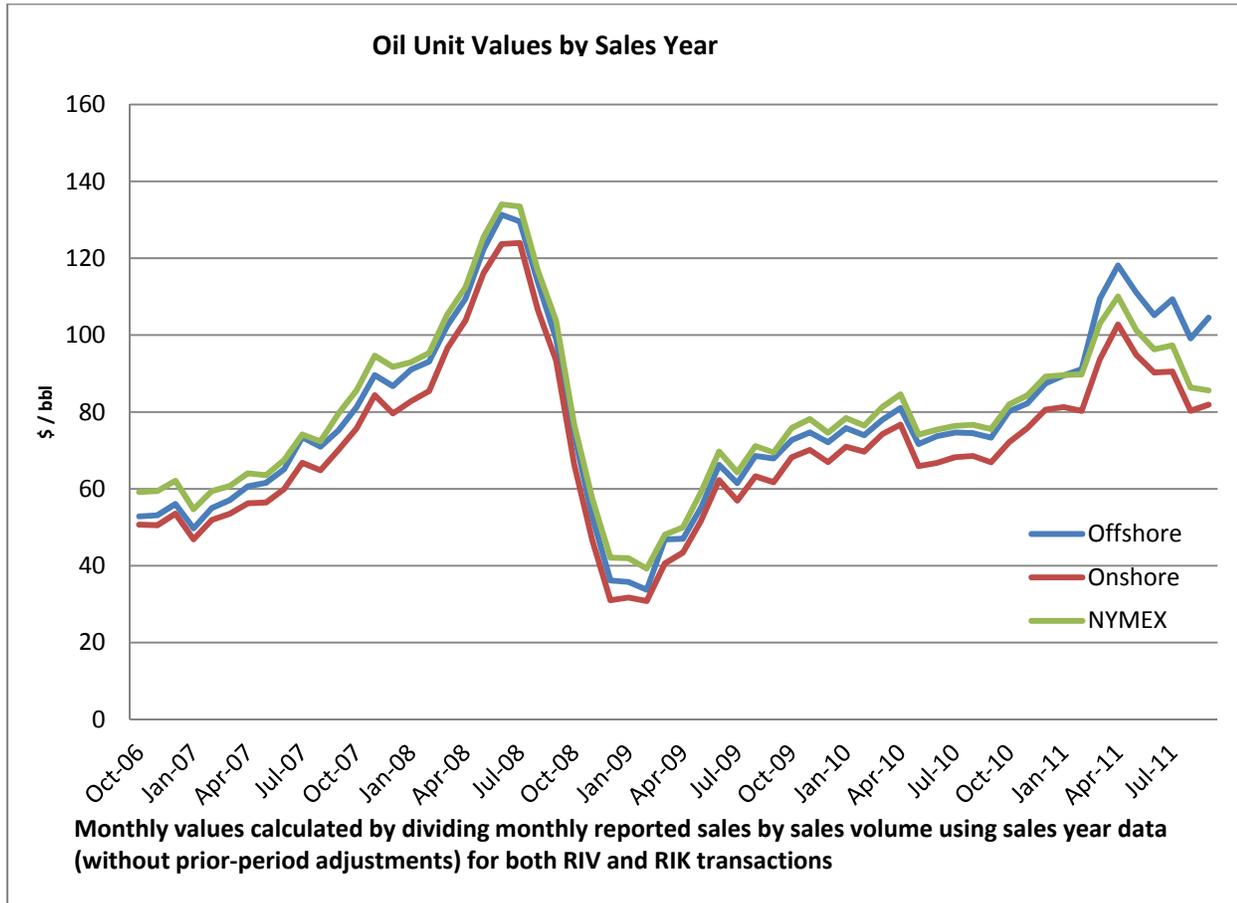


Offshore Federal oil production subject to royalty payments declined almost 13 percent from FY 2010 levels. This decline is due, in part, to continued declining production from many older, smaller GOM fields. As in 2010, the 2011 hurricane season was mild and did not significantly threaten GOM oil production.

Onshore crude oil production increased about 8 percent in FY 2011 with falling production rates from older onshore fields being more than offset by:

- Increasing oil production from North Dakota’s Bakken shale (a year over year increase of 50 percent and a 115 percent since FY 2009) and other onshore shale plays
- Increasing condensate production from onshore gas fields

Oil Value Observations:



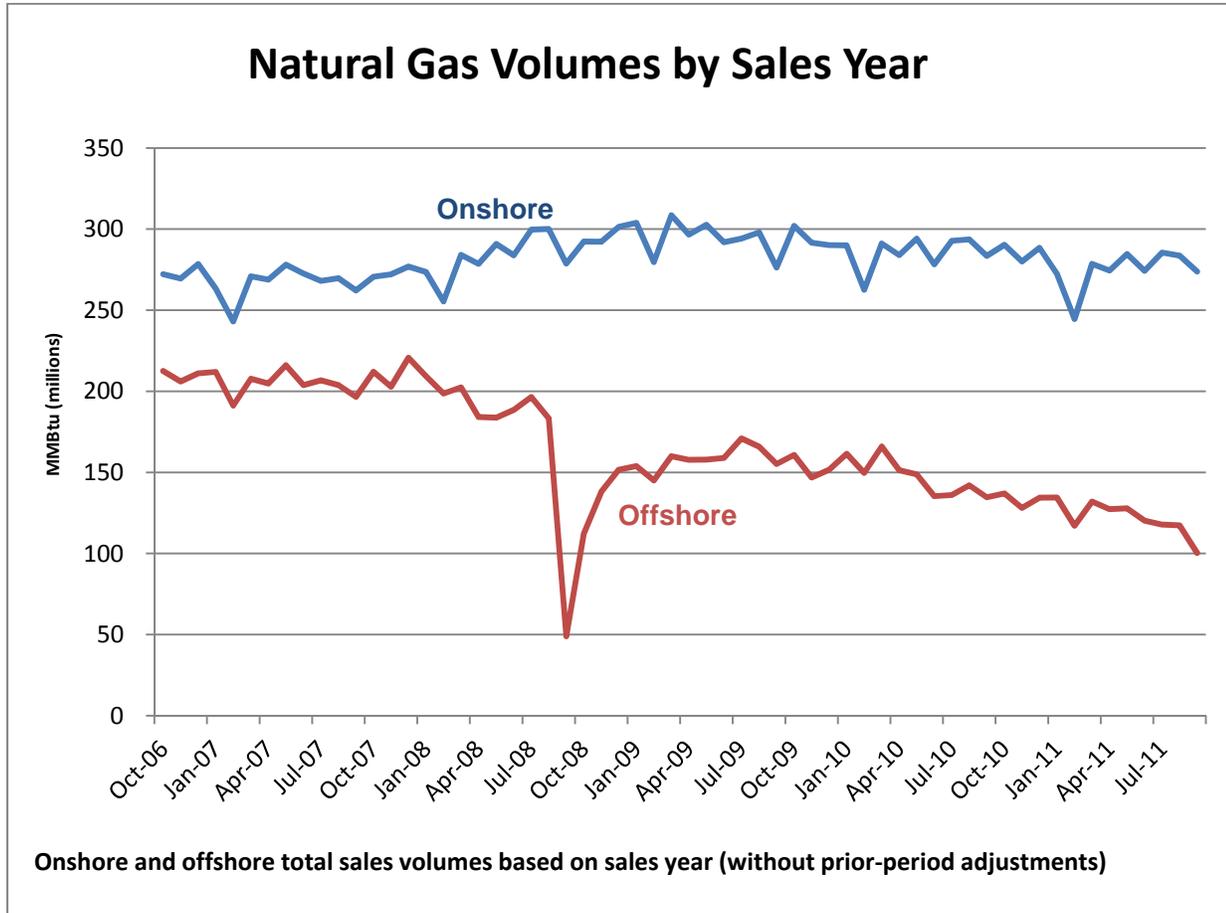
Oil prices in FY 2011 were more volatile than in 2010 but still significantly less volatile than in 2008 and 2009. The price spike in the spring of 2011 was caused primarily by market uncertainty around Libyan unrest and the resulting decrease in that country's exports. Resolution of the Libyan issue saw prices retreat from their highs towards the end of FY 2011.

Contrary to historical trends, offshore oil prices reported to ONRR began trading above the NYMEX WTI in 2011, averaging a \$6 premium. This is due primarily to the oversupply of oil in the US Midcontinent caused by increased production from shale plays and a lack of infrastructure to transport the oil away from Cushing depressing the NYMEX price. Future infrastructure improvements out of Cushing are expected to bring the WTI and offshore prices back to their historical relationships.

Onshore discounts to WTI narrowed in 2011 as increased production in light crudes from onshore shale formations offset declines from fields producing lower-priced heavier crude. Heavy crude is suitable for limited use in applications such as asphalt or roofing-material production.

Both onshore and offshore values reported to ONRR may also include deductions for transportation and pipeline quality considerations resulting in a reduction in unit value. Royalty regulations allow these deductions and they typically range from \$1 to \$2 per barrel offshore and under \$1 per barrel onshore.

Natural Gas Volume Observations:

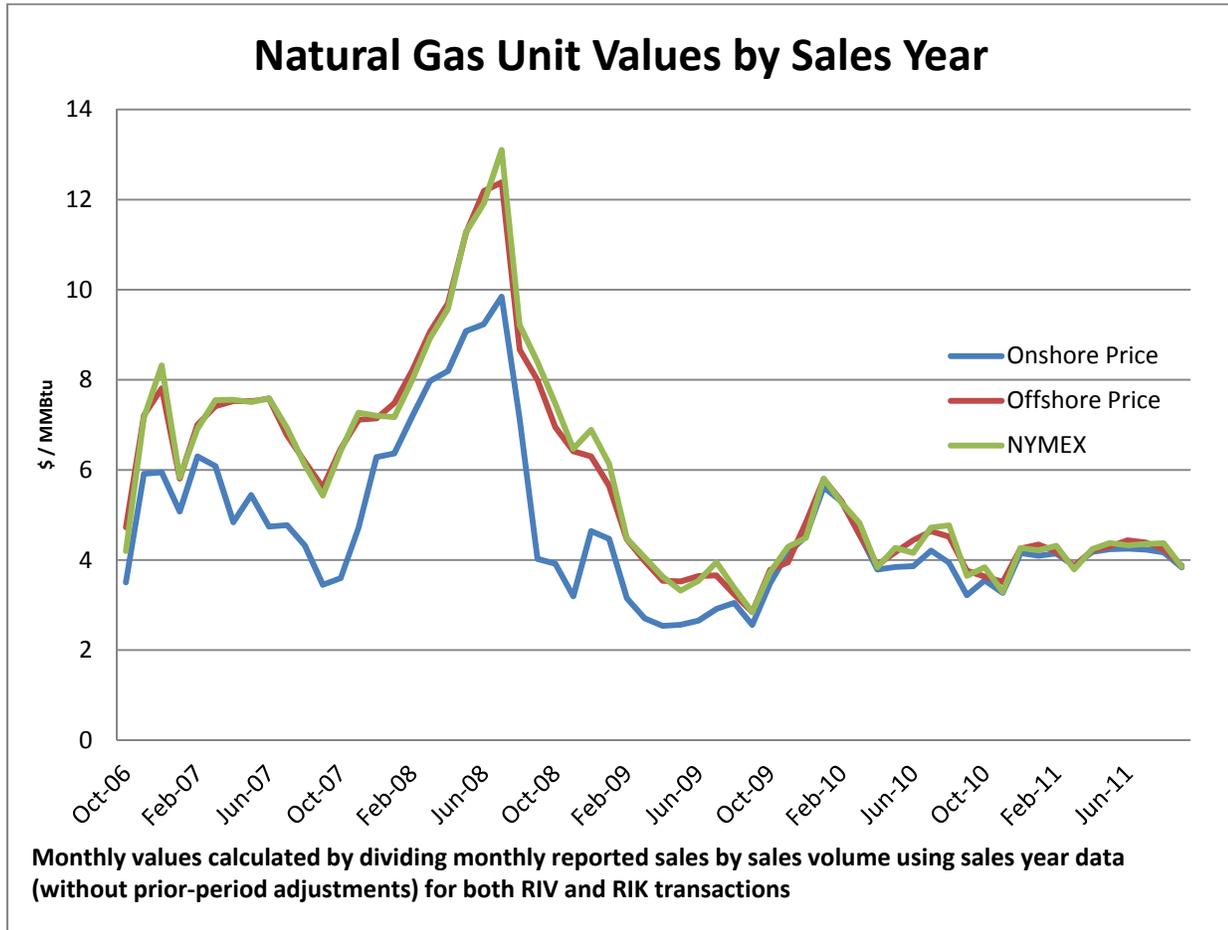


Federal gas production subject to royalty payments is steadily declining with volumes in FY 2011 down an average of 7 percent from FY 2010. There were no significant impacts in gas production from hurricanes in FY 2011.

GOM volumes declined over 15 percent in FY 2011. The same factors influencing the GOM oil decline contributed to the gas decline, although the weakness in natural gas prices also played a role.

Onshore gas production in FY 2011 decreased 3 percent from FY 2010 despite a boom in shale resources. In FY 2011, producers were targeting liquids-rich plays in order to capitalize on the high price of oil relative to gas, but most of these liquids-rich plays are in areas with little or no Federal production. Demonstrating this trend, May 2011 saw the number of rigs drilling for oil surpassing natural gas rigs. This lower production trend may continue into FY 2012 depending on the extent the lower prices dampen drilling.

Natural Gas Value Observations:

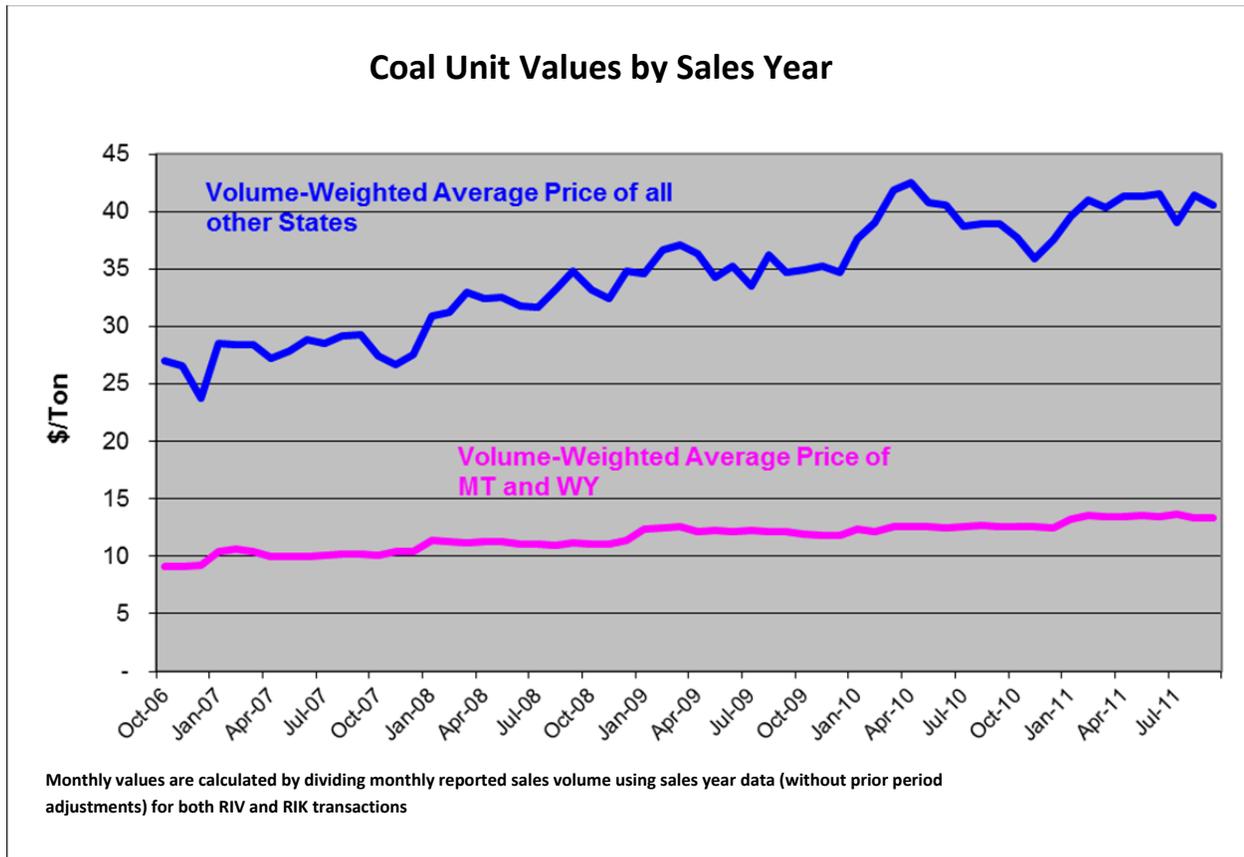


Natural gas prices were stable throughout FY 2011, although the average NYMEX value did decline 8 percent from FY 2010 reflecting strength in supply from unconventional shale resources in the Mid-Continent and Northeast. Storage withdrawals and freeze offs resulting from cold weather buoyed gas prices through February with the number of heating degree days surpassing the 30 year benchmark.

Offshore GOM prices reported to ONRR closely follow the average NYMEX Henry Hub value with some slight variance due to differences in local price indices and allowances for transportation and processing costs. Increased Marcellus shale gas production has displaced GOM gas that has historically provided supply to the Northeast and depressed GOM prices.

The average onshore price reported to ONRR in FY 2011 was very close to the average NYMEX price of \$4.10 per MMBtu. This narrowed spread is due to: (1) increased shale supply putting downward pressure on Henry Hub and (2) completed construction of several significant pipeline projects which move more gas from these discounted markets to more populated demand centers with stronger index values. In addition to the recently completed REX and Bison pipelines, Ruby pipeline entered into service in July 2011 connecting Opal Wyoming to Malin Oregon servicing the West Coast. These projects have greatly improved the price basis between the Rockies, the Mid-Continent and the Consuming East.

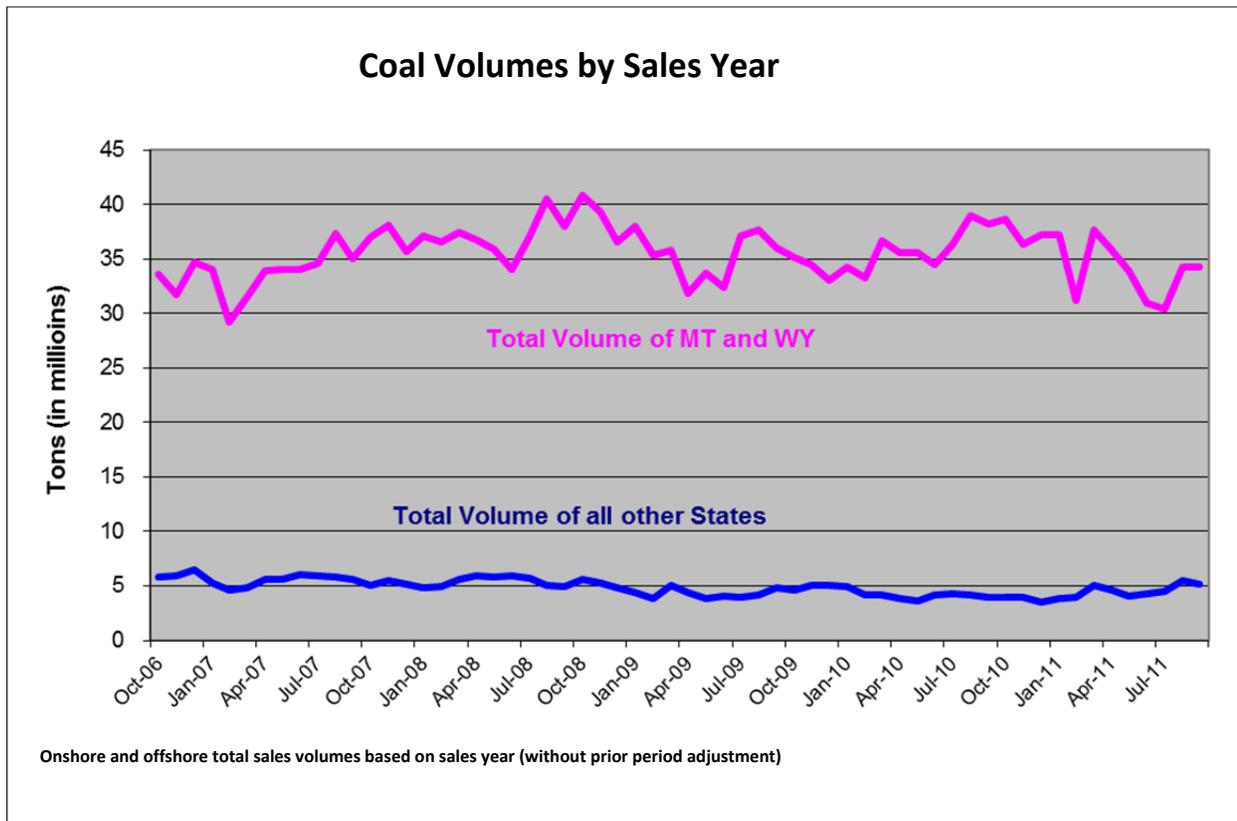
Coal Value Observations:



FY 2011 coal prices for Federal and Indian coal mines outside of the Powder River Basin region stayed just on par with FY 2010 prices. Western bituminous markets in Colorado and Utah stayed flat amid concerns over the basin's competitiveness, lack of demand, and continuing production challenges. Rail rates have made the coal uneconomic to destinations in the Eastern U.S. and for exports to Asia. Legacy contracts in the Powder River Basin buoyed federal coal prices, though the basin suffered from competition with low natural gas prices.

The value of coal-fired electricity generation assets fell about 10% in the first half of FY 2011, reported Barclay's Capital. They described the immediate relationship between coal and natural gas as "a forced marriage." Gas oversupply, power generation dynamics and abilities, and international coal markets are a few of the key issues related to the co-relationship between natural gas and coal. The transition of extra gas supplies into the electricity generation market has had a negative effect on coal.

Coal Volume Observations:



Coal production from mines containing Federal and Indian leases in Wyoming and Montana generally steadily declined on a month-over-month basis in FY 2011. Collectively, production from the area totaled 417,620,958 tons, a decline of two percent from the FY 2010 production totals. This decline was in line with national figures, as U.S. coal production fell just over two percent this year, according to the U.S. Energy Information Administration (EIA), as power generators worked through stockpiled inventories.

Powder River Basin coal production fell in mid-FY 2011 as widespread flooding and delayed trains prevented mines from shipping their full contract tonnage. The biggest decrease was at Peabody Energy's North Antelope Rochelle Mine, as its production fell over 13 percent. The huge snowmelt not only flooded the Missouri River, but also produced an unusually long hydroelectric season that dented coal sales. Abundant, cheap wind generation has also taken its toll on coal-fired generators, causing some units to ramp down in the off-peak periods.

For all regions outside of the Powder River Basin, coal production from mines containing Federal and Indian properties inched up just one-half of a percent from the prior fiscal year, totaling 52,399,294 tons. The federal West Elk mine in Colorado was the reason that coal production did not decrease in FY 2011, as the mine significantly ramped up production and sales this year. Without the increased federal production from the West Elk mine, overall coal production for these regions would have decreased over three percent from the prior fiscal year.

The total coal production from mines containing Federal and Indian properties was 470.02 million tons in FY 2011.

The share of U.S. electricity generated by coal during the second quarter of FY 2011 was at the lowest level in more than 30 years as power plants switched to natural gas. The EIA reported that coal provided 46 percent of total generation in the first quarter compared with 49 percent during the same three-month period in 2010 and 52 percent in the first quarter of 2008. Coal's share of electricity generation fell in all regions of the country. The trend of substituting competitively priced natural gas for more costly coal will likely continue due to lower marginal gas prices and rising coal prices.

In Colorado, Xcel Energy plans to shut various coal-fired units and replace their capacity with natural gas-fired generation. Xcel will spend about \$1.3 billion to retire over 1,500 MW of coal-fired generation. This decision is in response to a state law that requires the utility to propose reductions in nitrogen oxides by 70 percent to 80 percent by 2017 to meet anticipated federal clean air regulations.

Utah coal markets weakened as sellers grappled with ample supplies and more limited export avenues. Utah prices have been slowly whittled down by weak domestic utility demand and abundant, cheap hydropower. Consol Energy idled its federal Emery mine in Utah because of higher production costs and poor market conditions.

The business trend of coal producer mergers and buyouts continued in FY 2011, narrowing down the field of independent coal producers mining Federal and Indian coal resources. Alpha Natural Resources bought Massey Energy, creating a coal-producing giant with five billion tons of reserves. The company is the second-largest U.S. coal reserve owner and third-largest coal shipper. Chevron Mining divested itself of all of its remaining U.S. coal operations this year, including the federal Kemmerer and North River mines. Its collective coal mines produced nearly ten million tons in 2009, sold as steam coal to utilities. Chevron decided to exit the coal business after a review of operational and economic considerations.

The saving note for coal production and sales is exports. U.S. coal exports soared 26 percent in 2010 on an increase in steam and coking coal shipments to Asia, according to Census Bureau data. Europe was the largest single destination for exports but Asia was the second-largest recipient, leaping 133 percent above its 2009 level. Total U.S. coal exports rose almost 50% year-on-year during mid-FY 2011, representing the highest quarterly volume since 1992, as reported by the EIA. The agency estimates that U.S. coal exports will exceed 100 million tons in CY 2011, a 69 percent increase from CY 2009.

In lieu of protests, environmental groups and landowner have taken their fight to the courts. Wyoming landowners filed suit against the Bureau of Land Management, accusing the government of failing to evaluate the land and water impacts of mining coal from publicly leased tracts in the Powder River Basin. Environmental groups looking to block the expansion of a coal mine in western Colorado say the BLM did not consider the impacts to air quality and climate change when making its decision. The groups filed an appeal and a petition for stay with the Interior Board of Land Appeals regarding BLM's decision to offer for lease coal seams in the Elk Creek East tract, which would allow Oxbow Mining to expand its Elk Creek mine.

The federal government's coal leasing program in the Powder River Basin faced another legal challenge, after environmental groups joined forces to file a federal lawsuit against top officials at the Department of the Interior. The groups sought to have the government recertify the PRB as a "coal production region," reversing a 1990 decision by the Interior that allows for the current system of Leasing By Application.