CRANE CO /DE/
Form 10-Q
August 04, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Mark One:

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended June 30, 2008

OR

¨ **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: 1-1657

CRANE CO.

(Exact name of registrant as specified in its charter)

Delaware	**13-1952290**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

100 First Stamford Place, Stamford, CT	**06902**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: 203-363-7300

(Not Applicable)

(Former name, former address and former 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 registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark 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. (Check one):

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

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

The number of shares outstanding of the issuer s classes of common stock, as of July 31, 2008

Common stock, $1.00 Par Value 59,802,112 shares

Part I Financial Information

Item 1. Financial Statements

Crane Co. and Subsidiaries

Condensed Consolidated Statements of Operations

(in thousands, except per share data)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Net sales	$ 693,482	$ 660,897	$ 1,372,350	$ 1,289,115
Operating costs and expenses:				
Cost of sales	455,647	452,273	908,178	875,957
Selling, general and administrative	151,564	136,827	302,552	272,962
Operating profit	86,271	71,797	161,620	140,196
Other income (expense):				
Interest income	2,883	989	5,167	2,302
Interest expense	(6,678)	(6,901)	(13,183)	(13,769)
Miscellaneous net	1,631	931	1,961	2,744
	(2,164)	(4,981)	(6,055)	(8,723)
Income before income taxes	84,107	66,816	155,565	131,473
Provision for income taxes	25,098	21,080	48,178	42,092
Net income	$ 59,009	$ 45,736	$ 107,387	$ 89,381
Basic net income per share:	$ 0.99	$ 0.77	$ 1.79	$ 1.49
Diluted net income per share:	$ 0.97	$ 0.75	$ 1.77	$ 1.46
Average basic shares outstanding	59,707	59,767	59,911	60,039
Average diluted shares outstanding	60,581	60,882	60,812	61,096
Dividends per share	$ 0.18	$ 0.15	$ 0.36	$ 0.30

See Notes to Condensed Consolidated Financial Statements.

Crane Co. and Subsidiaries

Condensed Consolidated Balance Sheets

(in thousands, except share and per share data)

	(Unaudited) June 30, 2008	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 321,548	$ 283,370
Accounts receivable, net	377,844	345,176
Current insurance receivable asbestos	33,600	33,600
Inventories, net:		
Finished goods	123,564	109,337
Finished parts and subassemblies	41,605	39,108
Work in process	50,155	51,923
Raw materials	143,004	127,351
Inventories, net	358,328	327,719
Other current assets	61,486	47,757
Total current assets	1,152,806	1,037,622
Property, plant and equipment:		
Cost	774,700	749,968
Less: accumulated depreciation	481,687	460,285
Property, plant and equipment, net	293,013	289,683
Long-term insurance receivable asbestos	284,864	306,557
Long-term deferred tax assets	192,288	220,370
Other assets	124,673	128,360
Intangible assets, net	120,443	128,150
Goodwill	769,642	766,550
Total assets	$ 2,937,729	$ 2,877,292

See Notes to Condensed Consolidated Financial Statements.

Crane Co. and Subsidiaries

Condensed Consolidated Balance Sheets

(in thousands, except share and per share data)

	(Unaudited) June 30, 2008	December 31, 2007
Liabilities and shareholders equity		
Current liabilities:		
Notes payable and current maturities of long-term debt	$ 3,648	$ 548
Accounts payable	191,426	177,978
Current asbestos liability	84,000	84,000
Accrued liabilities	223,720	230,295
U.S. and foreign taxes on income	9,394	731
Total current liabilities	512,188	493,552
Long-term debt	398,390	398,301
Accrued pension and postretirement benefits	52,396	52,233
Long-term deferred tax liability	33,019	31,880
Long-term asbestos liability	904,469	942,776
Other liabilities	60,300	65,353
Total liabilities	1,960,762	1,984,095
Minority interest	8,326	8,394
Commitments and contingencies (Note 8)		
Shareholders equity:		
Preferred shares, par value $.01; 5,000,000 shares authorized		
Common stock, par value $1.00; 200,000,000 shares authorized, 72,426,139 shares issued	72,426	72,426
Capital surplus	152,254	148,513
Retained earnings	926,120	845,864
Accumulated other comprehensive income	175,557	154,077
Treasury stock	(357,716)	(336,077)
Total shareholders equity	968,641	884,803
Total liabilities and shareholders equity	$ 2,937,729	$ 2,877,292
Common stock issued	72,426,139	72,426,139
Less: Common stock held in treasury	(12,642,134)	(12,264,788)
Common stock outstanding	59,784,005	60,161,351

See Notes to Condensed Consolidated Financial Statements.

Crane Co. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(in thousands)

(Unaudited)

	Six Months Ended June 30,	
	2008	**2007**
Operating activities:		
Net income	$ 107,387	$ 89,381
Income from joint venture		(2,545)
Gain on divestitures	(932)	
Depreciation and amortization	29,695	31,068
Stock-based compensation expense	6,985	7,376
Deferred income taxes	11,865	(9,468)
Cash used for working capital	(46,288)	(46,132)
(Payments) receipts for asbestos-related fees and costs, net of insurance recoveries	(16,614)	15,208
Other	(2,601)	(14,131)
Total provided by operating activities	89,497	70,757
Investing activities:		
Capital expenditures	(20,401)	(21,831)
Proceeds from disposition of capital assets	444	11,236
Payment for acquisitions, net of cash acquired	(132)	145
Proceeds from divestiture	2,106	
Total used for investing activities	(17,983)	(10,450)
Financing activities:		
Equity:		
Dividends paid	(21,556)	(18,039)
Reacquisition of shares on the open market	(40,000)	(50,001)
Stock options exercised net of shares reacquired	9,091	7,144
Excess tax benefit from stock-based compensation	900	2,127
Debt:		
Repayments of long-term debt		(89)
Net increase in short-term debt	3,042	(8,608)
Total used for financing activities	(48,523)	(67,466)
Effect of exchange rates on cash and cash equivalents	15,187	3,627
Increase (decrease) in cash and cash equivalents	38,178	(3,532)
Cash and cash equivalents at beginning of period	283,370	138,607
Cash and cash equivalents at end of period	$ 321,548	$ 135,075
Detail of cash used for working capital:		
Accounts receivable	$ (27,912)	$ (51,482)
Inventories	(28,542)	(12,653)
Other current assets	(2,508)	742

Accounts payable	12,417	19,503
Accrued liabilities	(7,885)	1,645
U.S. and foreign taxes on income	8,142	(3,887)
Total	$ (46,288)	$ (46,132)
Supplemental disclosure of cash flow information:		
Interest paid	$ 13,129	$ 13,533
Income taxes paid	$ 25,905	$ 49,538

Part I Financial Information

Item 1. Financial Statements

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial reporting and the instructions to Form 10-Q and, therefore, reflect all adjustments which are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. These interim condensed consolidated financial statements should be read in conjunction with the Consolidated Financial Statements and Notes to Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

2. Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). This statement defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and expands disclosure about fair value measurements. In February 2008, the FASB issued Staff Positions No. SFAS 157-1 and No. SFAS 157-2 which delayed the effective date of SFAS No. 157 for one year for certain non-financial assets and non-financial liabilities and removed certain leasing transactions from its scope. The Company adopted SFAS 157 effective January 1, 2008 for financial assets and financial liabilities measured on a recurring basis (see Note 13, Fair Value Measurements). The Company is currently evaluating the provisions of SFAS 157-1 and SFAS 157-2 to determine the potential impact, if any, these staff positions will have on the Company s financial statements when they are applicable beginning in the first quarter of 2009.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), Business Combinations (SFAS 141(R)). SFAS No. 141(R) establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree and recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase. SFAS No. 141(R) also sets forth the disclosures required to be made in the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141(R) is effective for fiscal years beginning after December 15, 2008. The effects of the adoption of this standard in 2009 will be prospective.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51 (SFAS No. 160). SFAS No. 160 establishes accounting and reporting standards that require that the ownership interests in subsidiaries held by parties other than the parent be clearly identified, labeled, and presented in the consolidated statement of financial position within equity, but separate from the parent s equity; the amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented on the face of the consolidated statement of income; and changes in a parent s ownership interest while the parent retains its controlling financial interest in its subsidiary be accounted for consistently. SFAS No. 160 also requires that any retained noncontrolling equity investment in the former subsidiary be initially measured at fair value when a subsidiary is deconsolidated. SFAS No. 160 also sets forth the disclosure requirements to identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. The Company has not yet determined the anticipated effect, if any, of the adoption of this standard in 2009.

3. Segment Results

Financial information by reportable segment is set forth below:

(in thousands)	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Net Sales				
Aerospace & Electronics	$ 165,928	$ 160,172	$ 324,379	$ 308,564
Engineered Materials	72,937	87,712	155,710	175,461
Merchandising Systems	116,233	100,563	229,737	197,927
Fluid Handling	301,100	281,206	589,600	544,157
Controls	37,284	31,244	72,924	63,006
Total	$ 693,482	$ 660,897	$ 1,372,350	$ 1,289,115
Operating Profit (Loss)				
Aerospace & Electronics	$ 18,487	$ 24,365	$ 34,482	$ 45,391
Engineered Materials	8,100	17,933	19,754	33,971
Merchandising Systems	17,339	11,912	31,477	21,543
Fluid Handling	46,556	33,396	91,318	64,537
Controls	3,547	2,855	4,847	5,202
Corporate*	(7,758)	(18,664)	(20,258)	(30,448)
Total	86,271	71,797	161,620	140,196
Interest income	2,883	989	5,167	2,302
Interest expense	(6,678)	(6,901)	(13,183)	(13,769)
Miscellaneous net	1,631	931	1,961	2,744
Income before income taxes	$ 84,107	$ 66,816	$ 155,565	$ 131,473

* Second quarter 2008 operating results include $4.4 million of reimbursements related to environmental remediation activities. Second quarter 2007 operating results include a $7.6 million provision for a legal settlement.

(in thousands)	As of June 30, 2008	As of December 31, 2007
Assets		
Aerospace & Electronics	$ 472,795	$ 466,673
Engineered Materials	307,486	305,384
Merchandising Systems	362,807	348,914
Fluid Handling	929,417	868,873
Controls	84,202	84,390
Corporate	781,022	803,058
Total	$ 2,937,729	$ 2,877,292

4. Net Income Per Share

The Company s basic earnings per share calculations are based on the weighted average number of common shares outstanding during the period. Diluted earnings per share gives effect to all dilutive potential common shares outstanding during the period.

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands, except per share data)	**2008**	**2007**	**2008**	**2007**
Net income	$ 59,009	$ 45,736	$ 107,387	$ 89,381
Average basic shares outstanding	59,707	59,767	59,911	60,039
Effect of dilutive stock options	874	1,115	901	1,057
Average diluted shares outstanding	60,581	60,882	60,812	61,096
Basic net income per share	$ 0.99	$ 0.77	$ 1.79	$ 1.49
Diluted net income per share	$ 0.97	$ 0.75	$ 1.77	$ 1.46

Certain options granted under the Company s Stock Incentive Plan and the Non-Employee Director Stock Compensation Plan were not included in the computation of diluted earnings per share in the three-month and six-month periods ended June 30, 2008 and 2007 because they would not have had a dilutive effect (1.0 million and 0.7 million average options for the second quarter of 2008 and 2007, respectively, and 1.1 million and 1.0 million average options for the first half of 2008 and 2007, respectively).

5. Comprehensive Income

Total comprehensive income for the three-month and six-month periods ended June 30, 2008 and 2007 is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	**2008**	**2007**	**2008**	**2007**
Net income	$ 59,009	$ 45,736	$ 107,387	$ 89,381
Foreign currency translation adjustments	795	15,312	21,480	20,775
Comprehensive income	$ 59,804	$ 61,048	$ 128,867	$ 110,156

6. Goodwill and Intangible Assets

Changes to goodwill are as follows:

(in thousands)	Six Months Ended June 30, 2008	Year Ended December 31, 2007
Balance at beginning of period	$ 766,550	$ 704,736
Additions	227	46,406
Divestitures		(634)
Translation	2,865	16,042
Balance at end of period	$ 769,642	$ 766,550

Changes to intangible assets are as follows:

(in thousands)	Six Months Ended June 30, 2008	Year Ended December 31, 2007
Balance at beginning of period, net	$ 128,150	$ 122,744
Additions		19,409
Translation	748	3,886
Amortization expense	(8,455)	(17,889)
Balance at end of period, net	$ 120,443	$ 128,150

A summary of intangible assets follows:

	June 30, 2008		December 31, 2007	
(in thousands)	Gross Asset	Accumulated Amortization	Gross Asset	Accumulated Amortization
Intellectual property rights	$ 93,504	$ 46,212	$ 92,286	$ 43,720
Customer relationships and backlog	85,204	26,975	85,204	17,448
Drawings	10,825	9,914	10,825	9,681
Other	22,504	8,493	23,784	13,100
Total	$ 212,037	$ 91,594	$ 212,099	$ 83,949

Amortization expense for these intangible assets is currently estimated to be approximately $8.6 million for the remaining two quarters in 2008, $13.1 million in 2009, $11.9 million in 2010, $9.9 million in 2011, $8.3 million in 2012 and $49.7 million in 2013 and thereafter. Included within intangible assets is $18.9 million of intangibles with indefinite useful lives, consisting of trade names which are not being amortized in accordance with the guidance of Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets .

7. Accrued Liabilities

Accrued liabilities consist of:

(in thousands)	**June 30, 2008**	**December 31, 2007**
Employee related expenses	$ 90,913	$ 94,044
Warranty	29,097	32,218
Other	103,710	104,033
Total	$ 223,720	$ 230,295

8. Commitments and Contingencies

Asbestos Liability

Information Regarding Claims and Costs in the Tort System

As of June 30, 2008, the Company was a defendant in cases filed in various state and federal courts alleging injury or death as a result of exposure to asbestos. Activity related to asbestos claims during the periods indicated was as follows:

	Three Months Ended June 30,		**Six Months Ended June 30,**		**Year Ended December 31,**
	2008	**2007**	**2008**	**2007**	**2007**
Beginning claims	81,103	85,884	80,999	85,941	85,941
New claims	1,608	902	2,649	1,997	3,417
Settlements	(303)	(271)	(640)	(800)	(1,441)
Dismissals	(429)	(1,863)	(1,029)	(2,486)	(6,918)
Ending claims *	81,979	84,652	81,979	84,652	80,999

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* Does not include 36,374 maritime actions that were filed in the United States District Court for the Northern District of Ohio and transferred to the Eastern District of Pennsylvania pursuant to an order by the Federal Judicial Panel on Multi-District Litigation (MDL). These claims have been placed on the inactive docket of cases that are administratively dismissed without prejudice in the MDL.

Of the 81,979 pending claims as of June 30, 2008, approximately 25,000 claims were pending in New York, approximately 24,000 claims were pending in Mississippi, approximately 9,400 claims were pending in Texas and approximately 3,700 claims were pending in Ohio, all jurisdictions in which legislation or judicial orders restrict the types of claims that can proceed to trial on the merits.

Since the termination of the comprehensive master settlement agreement (MSA) on January 24, 2005, the Company has been resolving claims filed against it in the tort system. The Company has not re-engaged in discussions with representatives of current or future asbestos claimants with respect to such a comprehensive settlement. While the Company believes that federal legislation to establish a trust fund to compensate asbestos claimants is the most appropriate solution to the asbestos litigation problem, there is substantial uncertainty regarding whether this will occur and, if so, when and on what terms. The Company remains committed to exploring all feasible alternatives available to resolve its asbestos liability in a manner consistent with the best interests of the Company s shareholders.

Substantially all of the claims the Company resolves are concluded through settlements. The Company tried the Joseph Norris asbestos claim (the Norris Claim) to verdict in California, however, and received an adverse jury verdict on September 15, 2006. On October 10, 2006, the court entered judgment on this verdict against the Company in the amount of $2.15 million, together with interest thereon at the rate of 10% per annum until paid. The Company appealed the judgment, and on June 25, 2008, the Supreme Court of California declined to review an appellate court ruling adverse to the Company. The final judgment amount of $2.54 million was paid on July 14, 2008.

During the fourth quarter of 2007 and the first quarter of 2008, the Company tried several cases resulting in defense verdicts by the jury or directed verdicts for the defense by the court. However, on March 14, 2008, the Company received an adverse verdict in the James Baccus claim in Philadelphia, Pennsylvania, with compensatory damages of $2.45 million and additional damages of $11.9 million. The Company has filed a post-trial motion asserting numerous errors in the trial proceedings, and no judgment has been entered on the trial verdict. The Company intends to pursue all available rights to appeal the verdict.

On May 16, 2008 the Company received an adverse verdict in the Chief Brewer claim in Los Angeles, California. The amount of the judgment to be entered against the Company has not yet been determined, but it is not expected to exceed the $725,000 judgment requested by plaintiffs, plus interest and costs. Such judgment amounts are not included in the Company s incurred costs until available appeals are exhausted and the final payment amount is determined.

The gross settlement and defense costs incurred (before insurance recoveries and tax effects) by the Company in the six-month periods ended June 30, 2008 and 2007 totaled $43.4 million and $41.3 million, respectively. In contrast to the recognition of settlement and defense costs that reflect the current level of activity in the tort system, cash payments and receipts generally lag the tort system activity by several months or more, and may show some fluctuation from quarter to quarter. Cash payments of settlement amounts are not made until all releases and other required documentation are received by the Company, and reimbursements of both settlement amounts and defense costs by insurers may be uneven due to insurer payment practices, transitions from one insurance layer to the next excess layer and the payment terms of certain reimbursement agreements. The Company s total pre-tax cash receipts/payments for settlement and defense costs, including payments from insurers, in the six-month periods ended June 30, 2008 and 2007 totaled a $16.6 million net payment and $15.2 million net receipt (reflecting the January 2007 receipt of $31.5 million in previously escrowed funds from Equitas), respectively. Detailed below are the comparable amounts for the periods indicated.

	Three Months Ended June 30,		**Six Months Ended June 30,**		**Year Ended December 31,**	**Cumulative to Date Through June 30,**
(in millions)	**2008**	**2007**	**2008**	**2007**	**2007**	**2008**
Settlement costs incurred (1)	$ 13.5	$ 8.1	$ 25.6	$ 19.3	$ 41.6	$ 149.7
Defense costs incurred (1)	7.4	12.1	17.8	22.0	45.9	180.2
Total costs incurred	$ 20.9	$ 20.2	$ 43.4	$ 41.3	$ 87.5	$ 329.9
Pre-tax cash payments/(receipts)(2)	$ 14.6	$ 6.0	$ 16.6	$ (15.2)	$ 10.2	$ 152.6

(1) Before insurance recoveries and tax effects.

(2) Net of payments received from insurers, including a $31.5 million payment from Equitas in January 2007. Cumulative amounts include certain legal fees and expenses related to the terminated MSA in 2005.

The amounts shown for settlement and defense costs incurred, and cash payments, are not necessarily indicative of future period amounts, which may be higher or lower than those reported.

Effects on the Condensed Consolidated Financial Statements

The Company has retained the firm of Hamilton, Rabinovitz & Associates, Inc. (HR&A), a nationally recognized expert in the field, to assist management in estimating the Company s asbestos liability in the tort system. HR&A reviews information provided by the Company concerning claims filed, settled and dismissed, amounts paid in settlements and relevant claim information such as the nature of the asbestos-

related disease asserted by the claimant, the jurisdiction where filed and the time lag from filing to disposition of the claim. The methodology used by HR&A to project future asbestos costs is based largely on the Company s experience during the two full preceding calendar years (and additional quarterly periods to the estimate date) for claims filed, settled and dismissed. The Company s experience is then compared to the results of previously conducted epidemiological studies estimating the number of individuals likely to develop asbestos-related diseases. Those studies were undertaken in connection with national analyses of the population of workers believed to have been exposed to asbestos. Using that information, HR&A estimates the number of future claims that would be filed against the Company, as well as the related settlement or indemnity costs that would be incurred to resolve those claims. This methodology has been accepted by numerous courts. After discussions with the Company, HR&A augments its liability estimate for the costs of defending asbestos claims in the tort system using a forecast from the Company which is based upon discussions with its defense counsel. Based on this information, HR&A compiles an estimate of the Company s asbestos liability for pending and future claims, based on claim experience over the past two to three years and covering claims expected to be filed through the indicated period. Although the methodology used by HR&A will also show claims and costs for subsequent periods (up to and including the endpoint of the asbestos studies referred to above), management believes that the level of uncertainty regarding the various factors used in estimating future asbestos costs is too great to provide for reasonable estimation of the number of future claims, the nature of such claims or the cost to resolve them for years beyond the indicated estimate.

In the Company s view, the forecast period used to provide the best estimate for asbestos claims and related liabilities and costs is a judgment based upon a number of trend factors, including the number and type of claims being filed each year, the jurisdictions where such claims are filed and the effect of any legislation or judicial orders in such jurisdictions restricting the types of claims that can proceed to trial on the merits and the likelihood of any comprehensive asbestos legislation at the federal level. In addition, the dynamics of asbestos litigation in the tort system have been significantly affected over the past five to ten years by the substantial number of companies that have filed for bankruptcy protection, thereby staying any asbestos claims against them until the conclusion of such proceedings, and the establishment of a number of post-bankruptcy trusts for asbestos claimants, which are estimated to provide $25 billion for payments to current and future claimants. These trend factors have both positive and negative effects on the dynamics of asbestos litigation in the tort system and the related best estimate of the Company s asbestos liability, and these effects do not move in a linear fashion but rather change over multi-year periods. Accordingly, the Company s management monitors these trend factors over time and periodically assesses whether an alternative forecast period is appropriate.

Liability Estimate. With the assistance of HR&A, effective as of September 30, 2007, the Company updated and extended its estimate of the asbestos liability, including the costs of settlement or indemnity payments and defense costs relating to currently pending claims and future claims projected to be filed against the Company through 2017. The Company s previous estimate was for asbestos claims filed through 2011. As a result of this updated estimate, the Company recorded an additional liability of $586 million as of September 30, 2007. The Company s decision to take this action at such date was based on several factors. First, the number of asbestos claims being filed against the Company has moderated substantially over the past several years, and in the Company s opinion, the outlook for asbestos claims expected to be filed and resolved in the forecast period is reasonably stable. Second, these claim trends are particularly true for mesothelioma claims, which although constituting only 5% of the Company s total pending asbestos claims, have accounted for approximately 89% of the Company s aggregate settlement and defense costs over the past five years. Third, federal legislation that would significantly change the nature of asbestos litigation failed to pass in 2006, and in the Company s opinion, the prospects for such legislation at the federal level are remote. Fourth, there have been significant actions taken by certain state legislatures and courts over the past several years that have reduced the number and types of claims that can proceed to trial, which has been a significant factor in stabilizing the asbestos claim activity. Fifth, the Company has now entered into coverage-in-place agreements with a majority of its excess insurers, which enables the Company to project a more stable relationship between settlement and defense costs paid by the Company and reimbursements from its insurers. Taking all of these factors into account, the Company believes that it can reasonably estimate the asbestos liability for pending claims and future claims to be filed through 2017. While it is probable that the Company will incur additional charges for asbestos liabilities and defense costs in excess of the amounts currently provided, the Company does not believe that any such amount can be reasonably estimated beyond 2017. Accordingly, no accrual has been recorded for any costs which may be incurred for claims made subsequent to 2017.

Management has made its best estimate of the costs through 2017 based on the analysis by HR&A completed in October 2007. A liability of $1,055 million was recorded as of September 30, 2007 to cover the estimated cost of asbestos claims now pending or subsequently asserted through 2017, of which approximately 68% is attributable to settlement and defense costs for future claims projected to be filed through 2017. The liability is reduced when cash payments are made in respect of settled claims and defense costs. The liability was $988 million as of June 30, 2008. It is not possible to forecast when cash payments related to the asbestos liability will be fully expended; however, it is expected such cash payments will continue for a number of years past 2017, due to the significant proportion of future claims included in the estimated asbestos liability and the lag time between the date a claim is filed and when it is resolved.

Estimation of the Company s ultimate exposure for asbestos-related claims is subject to significant uncertainties, as there are multiple variables that can affect the timing, severity and quantity of claims. The Company cautions that its estimated liability is based on assumptions with respect to future claims, settlement and defense costs based on recent experience during the last few years that may not prove reliable as predictors. A significant upward or downward trend in the number of claims filed, depending on the nature of the alleged injury, the jurisdiction where filed and the quality of the product identification, or a significant upward or downward trend in the costs of defending claims, could change the estimated liability, as would substantial adverse verdicts at trial. A legislative solution or a revised structured settlement transaction could also change t="font-family: Times New Roman, Times, Serif; font-size: 10pt">**Position**

Begin End

Quantity

(mcf/d)

Price

Natural gas price swaps Bought 4/1/18 12/31/18 500 3.01

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Derivatives are recorded at fair value in the consolidated balance sheet. Changes in fair value are included in the “change in unrealized gain (loss) on oil price risk derivatives” in the consolidated statements of operations. For the three months ended March 31, 2018 and 2017, the Company’s unrealized gains (losses) from derivatives amounted to $0.1 and $0.0 million, respectively. Derivative contract settlements are included in the “realized gain (loss) on oil price risk derivatives” in the consolidated statement of operations. For the three months ended March 31, 2018 and 2017, the Company’s realized gain (loss) from derivatives amounted to $(0.2) and $0.0 million, respectively. All derivative positions are carried at their fair value on the condensed consolidated balance sheet and are included in “Commodity price risk derivatives.” The following table summarizes the fair value of our open commodity derivatives as of March 31, 2018, and December 31, 2017 (in thousands). Please see Note 13 for further disclosure.

	March 31, 2018			December 31, 2017		
Fair Value of Oil and Natural Gas Derivatives (in thousands)	Gross Amount	Amount Offset	As Presented	Gross Amount	Amount Offset	As Presented
Fair value of oil and natural gas derivatives – Current Assets	$126	$(126)	$ -	$168	$(168)	$ -
Fair value of oil and natural gas derivatives – Current Liabilities	(170)	63	(107)	(216)	55	(161)

6. OIL AND GAS PRODUCING ACTIVITIES

Ceiling Test and Impairment

The reserves used in the Company’s full cost ceiling test incorporate assumptions regarding pricing and discount rates in the determination of present value. In the calculation of the ceiling test as of March 31, 2018, the Company used a price of $50.27 per barrel for oil and $3.93 per MMbtu for natural gas (in each case adjusted for transportation, quality, and basis differentials applicable to our properties on a weighted average basis) to compute the future cash flows of the Company’s producing properties. These prices compare to $47.01 per barrel for oil and $2.98 per MMbtu for natural gas used in the calculation of the ceiling test as of December 31, 2017. The discount factor used was 10%.

For the three months ended March 31, 2018 and 2017, the Company recorded no impairment charges.

7. DEBT

On December 27, 2017, U.S. Energy Corp. received shareholder approval for the exchange agreement (“Exchange Agreement”) by and among the Company, the Company’s wholly owned subsidiary Energy One LLC and APEG Energy II, L.P., (“APEG”), an entity controlled by Angelus Private Equity Group, LLC pursuant to which, on the terms and subject to the conditions of the Exchange Agreement, APEG exchanged $4,463,380 of outstanding borrowings under the Company’s Credit Facility, for 5,819,270 new shares of common stock of the Company, par value $0.01 per share, with an exchange price of $0.767 representing a 1.3% premium over the 30-day volume weighted average price of the Company’s common stock on September 20, 2017 (the “Exchange Shares”). Accrued, unpaid interest on the Credit Facility held by APEG was paid in cash at the closing of the transaction. As of March 31, 2018, APEG holds approximately 47% of the outstanding Common Stock of U.S. Energy.

Energy One, a wholly-owned subsidiary of the Company, has a Credit Facility (the “Credit Facility”) with APEG Energy II, L.P. (“APEG”) which matures in July 2019. As of March 31, 2018, outstanding borrowings under the Credit Facility amounted to $0.9 million. Borrowings under the Credit Facility are secured by Energy One’s oil and gas producing properties. The interest rate on the Credit Facility is currently fixed at 8.75%.

Energy One is required to comply with customary affirmative covenants and with certain negative covenants. The principal negative financial covenants do not permit (as the following terms are defined in the Fifth Amendment to the Credit Agreement) (i) Proved Developed Producing Coverage Ratio to be less than 1.2 to 1; and (ii) the current ratio to be less than 1.0 to 1.0. Additionally, the Credit Agreement prohibits or limits Energy One’s ability to incur additional debt, pay cash dividends and other restricted payments, sell assets, enter into transactions with affiliates, and to merge or consolidate with another company. The Company is a guarantor of Energy One’s obligations under the Credit Agreement. As of March 31, 2018, the Company was in compliance with all Credit Facility covenants.

8. COMMITMENTS AND CONTINGENCIES

Commitments

Lessee Operating Leases. In August 2017, the Company entered into a lease agreement for office space in Denver, Colorado. The future minimum rental commitment under this sublease requires payments of $0.4 million

Year	Cash Commitment
2018	$ 52,819
2019	71,716
2020	73,125
2021	74,533
2022	75,941
2023	6,338

Contingencies

From time to time, the Company is party to certain legal actions and claims arising in the ordinary course of business. While the outcome of these events cannot be predicted with certainty, management does not expect these matters to have a materially adverse effect on the Company's financial position or results of operations. As of March 31, 2018, the Company was not subject to any contingent liabilities that would have a material impact to the financials.

9. SHAREHOLDERS' EQUITY

Preferred Stock

The Company's articles of incorporation authorize the issuance of up to 100,000 shares of preferred stock, $0.01 par value. Shares of preferred stock may be issued with such dividend, liquidation, voting and conversion features as may be determined by the Board of Directors without shareholder approval. The Company is authorized to issue 50,000 shares of Series P preferred stock in connection with a shareholder rights plan that expired in 2011. In February 2016 the Board of Directors approved the designation of 50,000 shares of Series A Convertible Preferred Stock in connection with the disposition of the Company's mining segment.

Common Stock

On January 5, 2018, we entered into a common stock sales agreement with a financial institution pursuant to which we may offer and sell, through the sales agent, common stock representing an aggregate offering price of up to $2.5 million through an at-the-market continuous offering program. During the quarter ended March 31, 2018 we issued an aggregate of 640,163 shares of common stock through our continuous at-the-market offering program at an average price of $1.47 per share for total proceeds of approximately $0.9 million.

Warrants

On December 21, 2016, the Company completed a registered direct offering of 1,000,000 shares of common stock at a net gross price of $1.50 per share. Concurrently, the investors received warrants to purchase 1,000,000 shares of Common Stock of the Company at an exercise price of $2.05 per share, subject to adjustment, for a period of five years from closing. The total net proceeds received by the Company was approximately $1.32 million. The fair value of the warrants upon issuance was $1.24 million, with the remaining $0.08 million being attributed to common stock. The warrants contain a dilutive issuance and other liability provisions which cause the warrants to be accounted for as a liability. Such warrant instruments are initially recorded as a liability and are accounted for at fair value with changes in fair value reported in earnings. As of March 31, 2018, the Company had a warrant liability of $0.9 million. As a result of common stock issuances made during the three months ended March 31, 2018, the warrant exercise price was reduced from $2.05 to $1.13 per share pursuant to the original warrant agreement.

Stock Options

From time to time, the Company grants stock options under its incentive plan covering shares of common stock to employees of the Company. Stock options, when exercised, are settled through the payment of the exercise price in exchange for new shares of stock underlying the option. These awards typically expire ten years from the grant date.

For the three months ended March 31, 2018 and 2017, total stock-based compensation expense related to stock options was $0.01 million and $0.1 million respectively. As of March 31, 2018, there was $0.08 million of unrecognized expense related to unvested stock options, which will be recognized as stock-based compensation expense through November 2019. For the three months ended March 31, 2018, no stock options were granted, exercised, forfeited or expired. Presented below is information about stock options outstanding and exercisable as of March 31, 2018 and December 31, 2017:

	March 31, 2018		December 31, 2017	
	Shares	**Price (1)**	Shares	**Price (1)**
Stock options outstanding	389,687	$8.05	389,687	$8.05
Stock options exercisable	279,687	$10.76	274,132	$10.79

(1) Represents the weighted average price.

The following table summarizes information for stock options outstanding and exercisable at March 31, 2018:

Options Outstanding					Options Exercisable	
Number of Shares	Exercise Price Range Low	High	Weighted Average	Remaining Contractual Term (years)	Number of Shares	Weighted Average Exercise Price
56,786	$9.00	$9.00	$ 9.00	6.8	56,786	$ 9.00
49,504	12.48	12.48	12.48	5.3	49,504	12.48
98,396	13.92	17.10	15.01	1.6	98,396	15.01

15,001	22.62	30.24	24.03	5.3	15,001	24.03
60,000	0.72	0.72	0.72	9.4	60,000	0.72
110,000	1.16	1.16	1.16	9.6	-	-
389,687	$0.72	$30.24	$ 8.05	6.4	279,687	$ 10.76

As of March 31, 2018, 981,008 shares are available for future grants under the Company's stock option plans.

10. INCOME TAXES

The Company has estimated the applicable effective tax rate expected for the full fiscal year. The Company's effective tax rate used to estimate income taxes on a current year-to-date basis for the three months ended March 31, 2018, and 2017, is 0% and 0%, respectively.

On December 27, 2017, as a result of a stock issuance (see Note 7) the gross deferred tax assets are subject to limitations under I.R.C. Section 382. The Company still maintains a gross deferred tax asset position that is subject to a valuation allowance.

Deferred tax assets ("DTAs") are recognized for the expected future tax consequences of temporary differences between the financial reporting and tax basis of assets and liabilities and for operating losses and tax credit carry forwards. We review our DTAs and valuation allowance on a quarterly basis. As part of our review, we consider positive and negative evidence, including cumulative results in recent years. Consistent with the position at December 31, 2017, the Company maintains a full valuation allowance recorded against all DTAs. The Company therefore had no recorded DTAs as of March 31, 2018. We anticipate that we will continue to record a valuation allowance against our DTAs in all jurisdictions of the Company until such time as we are able to determine that it is "more-likely-than-not" that those DTAs will be realized.

The Company recognizes, measures, and discloses uncertain tax positions whereby tax positions must meet a "more-likely-than-not" threshold to be recognized. During the quarters ended March 31, 2018 and 2017, no adjustments were recognized for uncertain tax positions.

The Company does not expect to pay any federal or state income taxes for the fiscal year ended December 31, 2018.

11. EARNINGS (LOSS) PER SHARE

Basic earnings (loss) per share is computed based on the weighted average number of common shares outstanding. For the three months ended March 31, 2018 and 2017, common stock equivalents excluded from the calculation of weighted average shares because they were antidilutive are as follows:

	2018	2017
Stock options	389,687	390,525
Unvested shares of restricted common stock	-	356,555
Total	389,687	747,080

12. SIGNIFICANT CONCENTRATIONS

The Company has exposure to credit risk in the event of nonpayment by the joint interest operators of the Company's oil and gas properties. Approximately 84% of the Company's proved developed oil and gas reserve value is associated with properties that are operated by three operators: Operator A: 62%, Operator B: 13% and Operator C: 9%.

13. FAIR VALUE MEASUREMENTS

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In determining fair value, the Company uses various methods including market, income and cost approaches. Based on these approaches, the Company often utilizes certain assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable inputs. The Company utilizes valuation techniques that maximize the use of

observable inputs and minimize the use of unobservable inputs. Based on the observability of the inputs used in the valuation techniques the Company is required to provide the following information according to the fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories:

Level 1 - Quoted prices for identical assets and liabilities traded in active exchange markets, such as the New York Stock Exchange.

Level 2 - Observable inputs other than Level 1 including quoted prices for similar assets or liabilities, quoted prices in less active markets, or other observable inputs that can be corroborated by observable market data. Level 2 also includes derivative contracts whose value is determined using a pricing model with observable market inputs or can be derived principally from or corroborated by observable market data.

Level 3 - Unobservable inputs supported by little or no market activity for financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation; also includes observable inputs for nonbinding single dealer quotes not corroborated by observable market data.

The Company has processes and controls in place to attempt to ensure that fair value is reasonably estimated. The Company performs due diligence procedures over third-party pricing service providers in order to support their use in the valuation process. Where market information is not available to support internal valuations, independent reviews of the valuations are performed and any material exposures are evaluated through a management review process.

While the Company believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. The following is a description of the valuation methodologies used for complex financial instruments measured at fair value:

Marketable Equity Securities Valuation Methodologies

The fair value of available for sale securities is based on quoted market prices obtained from independent pricing services. Accordingly, the Company has classified these instruments as Level 1.

Derivative Assets and Liabilities

Derivative assets and liabilities, at fair value, are included on our consolidated balance sheets as current or non-current assets or liabilities based on the anticipated timing of cash settlements under the related contracts. Changes in the fair value of our commodity derivative contracts, not designated as cash-flow hedges, are recorded in earnings as they occur and included in income (expense) on our consolidated statements of operations. We estimate the fair values of swap contracts based on the present value of the difference in exchange-quoted forward price curves and contractual settlement prices multiplied by notional quantities. Accordingly, the Company has classified these instruments as Level 2.

Warrant Valuation Methodologies

The warrants contain a dilutive issuance and other liability provisions which cause the warrants to be accounted for as a liability. Such warrant instruments are initially recorded and valued as a level 3 liability and are accounted for at fair value with changes in fair value reported in earnings.

The Company estimated the value of the warrants issued in connection with the closing of its registered direct offering on December 21, 2016 on March 31, 2017 to be $1,030,000, or $1.03 per warrant, using the Monte Carlo model with the following assumptions: a term expiring June 21, 2022, exercise price of $2.05, stock price of $1.28, average volatility rate of 90%, and a risk-free interest rate of 2.01%. The Company re-measured the warrants as of March 31, 2018, using the same Monte Carlo model, using the following assumptions: a term expiring June 21, 2022, exercise price of $1.13, stock price of $1.23, average volatility rate of 95%, and a risk-free interest rate of 2.5%. The "ratchet" anti-dilution provision in the warrants may result in the downward adjustment of the exercise price of the warrants. If the Company issues common stock, options or common stock equivalents at a price less than the exercise price of the warrants, subject to certain customary exceptions, the exercise price of the warrants is reduced to that lower price, however in no event will the exercise price be reduced below $.392 per share. As of March 31, 2018, the fair value of the warrants was $930,000, or $0.93 per warrant, and was recorded as a liability on the accompanying consolidated balance sheets. An increase in any of the variables would cause an increase in the fair value of the warrants. Likewise, a decrease in any variable would cause a decrease in the value of the warrants.

Other Financial Instruments

The carrying amount of cash and equivalents, oil and gas sales receivable, other current assets, accounts payable and accrued expenses approximate fair value because of the short-term nature of those instruments. The recorded amounts for the Credit Facility discussed in Note 7 approximates the fair market value due to the variable nature of the interest rates, and the fact that market interest rates have remained substantially the same since the latest amendment to the Credit Facility.

Recurring Fair Value Measurements

Recurring measurements of the fair value of assets and liabilities as of March 31, 2018 and December 31, 2017 are as follows:

	March 31, 2018				December 31, 2017			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Marketable equity securities:								
Sutter Gold Mining Company	$-	$10	$-	$10	$-	$8	$-	$8
Anfield Resources, Inc.	788	-	-	788	868	-	-	868
Total	$788	$10	$-	$798	$868	$8	$-	$876
Commodity price risk derivatives	$-	$107	-	$107	-	$161	-	$161
Outstanding warrant liability	-		930	930	$-	-	1,200	1,200
Total	$-	$107	$930	$1,037		$161	$1,200	$1,361

The following table presents a reconciliation of changes in liabilities measured at Level 3 fair value on a recurring basis for the period ended March 31, 2018 and the year ended December 31, 2017.

	Liabilities Warrants (Level 3)	Net
Fair value, December 31, 2017	$ 1,200	$1,200
Total net losses included in:		
Other comprehensive loss	-	-
Fair value adjustments included in net loss:		
Net unrealized gain on warrant fair value adjustment	(270)	(270)
Fair value, March 31, 2018	$ 930	$930

14. SUBSEQUENT EVENTS

None.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward Looking Statements

This Form 10-Q contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). All statements other than statements of historical facts included in and incorporated by reference into this Form 10-Q are forward-looking statements. When used in this Form 10-Q, the words "will", "expect", "anticipate", "intend", "plan", "believe", "seek", "estimate" and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain these identifying words. Forward-looking statements in this Form 10-Q include statements regarding our expected future revenue, income, production, liquidity, cash flows, reclamation and other liabilities, expenses and capital projects, future capital expenditures and future transactions. Because these forward-looking statements involve risks and uncertainties, actual results could differ materially from those expressed or implied by these forward-looking statements due to a variety of factors, including those associated with our ability to find oil and natural gas reserves that are economically recoverable, the volatility of oil, NGL and natural gas prices, declines in the values of our properties that have resulted in and may in the future result in additional ceiling test write downs, our ability to replace reserves and sustain production, our estimate of the sufficiency of our existing capital sources, our ability to raise additional capital to fund cash requirements for our participation in oil and gas properties and for future acquisitions, the uncertainties involved in estimating quantities of proved oil and natural gas reserves, in prospect development and property acquisitions or dispositions and in projecting future rates of production or future reserves, the timing of development expenditures and drilling of wells, hurricanes and other natural disasters and the operating hazards attendant to the oil and gas and minerals businesses. In particular, careful consideration should be given to cautionary statements made in the "Risk Factors" section of our 2017 Annual Report on Form 10-K and other quarterly reports on Form 10-Q filed with the SEC, all of which are incorporated herein by reference. The Company undertakes no duty to update or revise any forward-looking statements.

General Overview

We are an independent energy company focused on the lease acquisition and development of oil and gas producing properties in the continental United States. Our business is currently focused in South Texas and the Williston Basin in North Dakota. However, we do not intend to limit our focus to these geographic areas. We continue to focus on increasing production, reserves, revenues and cash flow from operations while managing our level of debt.

We currently explore for and produce oil and gas through a non-operator business model; however, we may operate oil and gas properties for our own account and may expand our holdings or operations into other areas. As a non-operator, we rely on our operating partners to propose, permit and manage wells. Before a well is drilled, the operator is required to provide all oil and gas interest owners in the designated well the opportunity to participate in

the drilling costs and revenues of the well on a pro-rata basis. After the well is completed, our operating partners also transport, market and account for all production. As discussed in Item 1. Business, our long-term strategic focus is to develop operational capabilities through the pursuit of opportunities to acquire operated properties and/or operatorship of existing properties.

Recent Developments

On January 5, 2018, we entered into a common stock sales agreement with a financial institution pursuant to which we may offer and sell from time to time, through the sales agent, common stock representing an aggregate offering price of up to $2.5 million through an at-the-market offering program as defined in Rule 415 under the Securities Act of 1933, as amended. During the quarter ended March 31, 2018 we issued an aggregate 640,163 shares of common stock through our continuous at-the-market offering program at an average price of $1.47 per share for total proceeds of approximately $0.9 million.

Critical Accounting Policies and Estimates

The preparation of our consolidated financial statements in conformity with generally accepted accounting principles in the United States (“GAAP”) requires us to make assumptions and estimates that affect the reported amounts of assets, liabilities, revenues and expenses, as well as the disclosure of contingent assets and liabilities at the date of our financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from these estimates under different assumptions or conditions. A summary of our significant accounting policies is detailed in *Note 7 – Management’s Discussion and Analysis of Financial Conditions and Results of Operations* in Item 2 of our 2017 Annual Report on Form 10-K filed with the SEC on March 28, 2018.

Recently Issued Accounting Standards

Please refer to the section entitled *Recent Accounting Pronouncements* under *Note 1 – Organization, Operations and Significant Accounting Policies* in the Notes to the Financial Statements included in Item 1 of this report for additional information on recently issued accounting standards and our plans for adoption of those standards.

Results of Operations

Comparison of our Statements of Operations for the Three Months Ended March 31, 2018 and 2017

During the three months ended March 31, 2018, we recorded a net loss of $0.2 million as compared to a net loss of $0.7 million for the three months ended March 31, 2017. In the following sections we discuss our revenue, operating expenses, non-operating income, and discontinued operations for the three months ended March 31, 2018 compared to the three months ended March 31, 2017.

Revenue. Presented below is a comparison of our oil and gas sales, production quantities and average sales prices for the three months ended March 31, 2018 and 2017 (dollars in thousands, except average sales prices):

			Change	
	2018	2017	Amount	Percent
Revenue:				

Oil	$1,230	$1,240	$(10	)	-1 %
Gas	325	507	(182	)	-36 %
Total	$1,555	$1,747	$(192	)	-11 %
Production quantities:					
Oil (Bbls)	20,379	29,036	(8,657	)	-30 %
Gas (Mcfe)	102,205	125,095	(22,890	)	-18 %
BOE	37,413	49,885	(12,472	)	-25 %
Average sales prices:					
Oil (Bbls)	$60.39	$42.69	$17.70		41 %
Gas (Mcfe)	3.18	4.06	(0.88	)	-22 %
BOE	41.57	35.02	6.55		19 %

The decrease in our oil and gas revenue of $0.2 million for the three months ended March 31, 2018 as compared to the three months ended March 31, 2017 was primarily attributable to the October 2017 asset divestiture which offset a 41% increase in in the average oil sales price received for the three months ended March 31, 2018 as compared to the three months ended March 31, 2017. The decrease in our gas sales of $0.2 million for the three months ended March 31, 2018 as compared to the three months ended March 31, 2017 was due in part to the October 2017 asset divestiture and normal production declines.

For the three months ended March 31, 2018, we produced 37,413 BOE, or an average of 416 BOE per day, as compared to 49,885 BOE or 554 BOE per day during the comparable period in 2017. This reduction was mainly attributable to the October 2017 asset divestiture combined with normal production declines.

Oil and Gas Production Costs. Presented below is a comparison of our oil and gas production costs for the three months ended March 31, 2018 and 2017 (dollars in thousands):

	2018	2017	Change Amount	Change Percent
Production taxes and other expenses	$209	$353	$(144)	-41 %
Lease operating expenses	424	700	(276)	-39 %
Total	$633	$1,053	$(420)	-40 %

For the three months ended March 31, 2018, production taxes and other expenses decreased by $0.1 million compared to the comparable period in 2017. This decrease in production taxes and other expenses was primarily attributable to the October 2017 asset divestiture. During the three months ended March 31, 2018, lease operating expenses decreased by $0.3 million when compared to the three months ended March 31, 2017. The decrease was primarily attributable to the October 2017 asset divestiture.

Depreciation, depletion and amortization. Our DD&A rate for the three months ended March 31, 2018 was $3.70 per BOE compared to $5.25 per BOE for the three months ended March 31, 2017. Our DD&A rate can fluctuate as a result of changes in drilling and completion costs, impairments, divestitures, changes in the mix of our production, the underlying proved reserve volumes and estimated costs to drill and complete proved undeveloped reserves. The primary factor that resulted in a reduction in our DD&A rate for the three months ended March 31, 2018 was the October 2017 asset divestiture and the corresponding reduction to the Company's full cost pool.

Impairment of oil and gas properties. During the three months ended March 31, 2018 and 2017, we recorded no impairment charges related to our oil and gas properties due to the net capitalized costs being in excess of the full cost ceiling limitation. Presented below are the weighted average prices (in each case adjusted for transportation, quality, and basis differentials applicable to our properties on a weighted average basis) used to prepare our reserve estimates and to calculate our Full Cost Ceiling limitations for each of the last five calendar quarters:

	Average Price [1]	
	Oil (Bbl)	Gas (MMbtu)

First quarter of 2017	$42.09	$ 2.65
Second quarter of 2017	42.56	2.94
Third quarter of 2017	43.89	2.92
Fourth quarter of 2017	47.01	2.98
First quarter of 2018	50.27	3.93

(1) Represents the trailing 12-month average for benchmark oil and gas prices ending in the last month of the calendar quarter shown.

Our quarterly reserve reports are prepared based on a trailing 12-month average for benchmark oil and gas prices.

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General and Administrative Expenses. Presented below is a comparison of our general and administrative expenses for the three months ended March 31, 2018 and 2017 (dollars in thousands):

	2018	2017	Change Amount	Percent
Compensation and benefits, including directors	$783	$176	$607	349 %
Stock-based compensation	13	106	(93)	-88 %
Professional fees	234	880	(646)	-73 %
Insurance, rent and other	86	101	(15)	-15 %
Total	$1,116	$1,263	$(147)	-12 %

General and administrative expenses were $1.1 million during the first quarter of 2018 as compared to $1.3 million during the first quarter of 2017. The decrease was primarily attributable to a $0.7 million reduction in professional fees due to the completion of Company transactions during 2017 offset by a $0.6 million increase in employee cash compensation.

Non-Operating Income (Expense). Presented below is a comparison of our non-operating income (expense) for the three months ended March 31, 2018 and 2017 (dollars in thousands):

	2018	2017	Change Amount	Percent
Realized loss on oil price risk derivatives	$(179)	$-	$(179)	N/A
Unrealized gain on oil price risk derivatives	54	-	54	N/A
Rental and other income (expense), net	(14)	(28)	14	50 %
Warrant revaluation gain	270	340	(70)	-21 %
Interest expense	(36)	(125)	89	-71 %
Employee Arbitration Settlement	-	(188)	188	N/A
Other expense	-	(1)	1	N/A
Total other income (expense)	$95	$(2)	$97	4,850 %

During the three months ending March 31, 2018, the Company had a realized loss on oil price derivatives of $0.2 million. During the three months ending March 31, 2017, the Company had no outstanding crude derivative contacts outstanding. Unrealized gains or losses result from changes in the fair value of the derivatives as commodity prices increase or decrease. Unrealized losses are also recognized in the month when derivative contracts are settled in cash through the recognition of a realized gain. Similarly, unrealized gains are also recognized in the month when derivative contracts are settled in cash through the recognition of a realized loss.

During the three months ending March 31, 2018, we realized a warrant revaluation gain of $0.3 million as compared to a gain of $0.3 million during the three months ending March 31, 2017. Our warrant liability is accounted for using the mark-to-market accounting method whereby gains and losses from changes in the fair value of derivative instruments are recognized immediately into earnings. We will continue to revalue our outstanding warrants on a quarterly basis.

Interest expense decreased by $0.1 million during the three months ended March 31, 2018 compared to the comparable period in 2017. The decrease was attributable to the reduction in the principle balance of our credit facility. The average interest rate increased to 8.40% for the three months ended March 31, 2018 in comparison to 7.39% for the three months ended March 31, 2017.

Non-GAAP Financial Measures- Adjusted EBITDAX

Adjusted EBITDAX represents income (loss) from continuing operations as further modified to eliminate impairments, depreciation, depletion and amortization, stock-based compensation expense, loss on investments and other non-operating income or expense, income taxes, unrealized derivative gains and losses, interest expense, exploration expense, and other items set forth in the table below. Adjusted EBITDAX excludes certain items that we believe affect the comparability of operating results and can exclude items that are generally one-time in nature or whose timing and/or amount cannot be reasonably estimated.

Adjusted EBITDAX is a non-GAAP measure that is presented because we believe it provides useful additional information to investors and analysts as a performance measure. In addition, adjusted EBITDAX is widely used by professional research analysts and others in the valuation, comparison, and investment recommendations of companies in the oil and gas exploration and production industry, and many investors use the published research of industry research analysts in making investment decisions. Adjusted EBITDAX should not be considered in isolation or as a substitute for net income (loss), income (loss) from operations, net cash provided by operating activities, or profitability or liquidity measures prepared under GAAP. Because adjusted EBITDAX excludes some, but not all items that affect net income (loss) and may vary among companies, the adjusted EBITDAX amounts presented may not be comparable to similar metrics of other companies. Our wholly-owned subsidiary, Energy One LLC, is also subject to a debt to adjusted EBITDAX ratio as one of the financial covenants under its Credit Facility and the calculation for purposes of the Credit Facility differs from our financial reporting definition.

The following table provides reconciliations of income (loss) from continuing operations to adjusted EBITDAX for the three months ended March 31, 2018 and 2017:

	2018	2017
Loss from continuing operations (GAAP)	$(244)	$(740)
Depreciation, depletion and amortization	145	304
Unrealized gain on oil price risk derivatives	(54)	-
Stock-based compensation	13	106
Warrant fair value adjustment (gain) loss	(270)	(340)
Interest expense	36	125
Total	$(374)	$(545)

Liquidity and Capital Resources

The following table sets forth certain measures of our liquidity as of March 31, 2018 and December 31, 2017:

	2018	2017	Change
Cash and equivalents	$ 2,095	$ 3,277	$ (1,182)
Working capital [1]	4,122	4,336	(214)
Total assets	14,697	15,316	(619)
Outstanding debt under Credit Facility	937	1,537	(600)
Borrowing base under Credit Facility	6,000	6,000	-
Total shareholders’ equity	11,230	10,662	568

Select Ratios		
Current ratio [2]	7.3 to 1.0	3.7 to 1.0
Debt to equity ratio [3]	0.1 to 1.0	0.1 to 1.0

(1) Working capital deficit is computed by subtracting total current liabilities from total current assets.

(2) The current ratio is computed by dividing total current assets by total current liabilities.

(3) The debt to equity ratio is computed by dividing total debt by total shareholders' equity.

As of March 31, 2018, we have working capital of $4.1 million compared to working capital of $4.3 million as of December 31, 2017, a decrease of $0.2 million. This decrease was primarily attributable to a $0.7 million reclassification on the Company's Consolidated Balance Sheet of "Assets available for sale" to "Property and equipment, net" offset by a $0.4 million increase in "Oil and gas sales receivable" and $0.1 million reduction in "Liabilities from derivative contracts."

Our sole source of debt financing is a revolving Credit Facility with APEG Energy II, LP. The borrowing base has been held constant at $6.0 million as of March 31, 2018 and December 31, 2017. Outstanding borrowings as of March 31, 2018 were $0.9 million with borrowing availability of $5.1 million as of March 31, 2018. As of March 31, 2018, we were in compliance will all financial covenants associated with the Credit Facility.

On January 5, 2018, we entered into a common stock sales agreement with a financial institution pursuant to which we may offer and sell, from time to time, through the sales agent, common stock representing an aggregate offering price of up to $2.5 million through an at-the-market offering program. During the quarter ended March 31, 2018 we issued an aggregate 640,163 shares of common stock through our continuous at-the-market offering program at an average price of $1.47 per share for total proceeds of approximately $0.9 million.

As of March 31, 2018, we had cash and equivalents of $2.1 million, and we expect to maintain cash balances in this range for some time. We also expect potential investors and lenders will find our singular industry focus, combined with attractive producing properties and a low-cost overhead structure to be an attractive vehicle to partner with the Company. However, there can be no assurance that we will be able to complete future transactions on acceptable terms or at all.

If we have unanticipated needs for financing in 2018, alternatives that we will consider if necessary include selling or joint venturing an interest in some of our oil and gas assets, selling our real estate assets in Wyoming, selling our marketable equity securities, issuing shares of our common stock for cash or as consideration for acquisitions, and other alternatives, as we determine how to best fund our capital programs and meet our financial obligations. Our capital expenditure plan and our ability to obtain sufficient funding to make anticipated capital expenditures and satisfy our financial obligations are subject to numerous risks and uncertainties, including those discussed in Risk Factors in our 2017 Annual Report on Form 10-K filed on March 28, 2018.

Cash Flows

The following table summarizes our cash flows for the three months ended March 31, 2018 and 2017 (in thousands):

	2018	2017	Change
Net cash provided by (used in):			
Operating activities	$(1,413)	$(333)	$(1,080)
Investing activities	(46)	(21)	(25)
Financing activities	277	-	277

Operating Activities. Cash used in operating activities for the three months ended March 31, 2018 was $1.4 million as compared to cash used by operated activities $0.3 million for the comparable period in 2017. The increased cash use is attributed to an increase in general and administrative expenses along with diligence expenses associated with potential transactions.

Investing Activities. Cash used in investing activities for the three months ended March 31, 2018 was $0.04 million as compared to $0.02 million for the comparable period in 2017. The primary use of cash in our investing activities for the three months ended March 31, 2018 was capital expenditures associated with operations.

Financing Activities. Cash generated by financing activities for the three months ended March 31, 2018 was $0.3 million as compared to no activity for the comparable period in 2017. The increase during the quarter ended March 31, 2018 was primarily attributable to $0.9 million in proceeds from the at-the-market offering program offset by a $0.6 million debt reduction payment.

Off-balance Sheet Arrangements

As part of our ongoing business, we have not participated in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities ("SPEs"), which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

We evaluate our transactions to determine if any variable interest entities exist. If it is determined that we are the primary beneficiary of a variable interest entity, that entity will be consolidated in our consolidated financial statements. We have not been involved in any unconsolidated SPE transactions during the periods covered by this report.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

As a smaller reporting company, we are not required to provide the information under this Item.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Based on an evaluation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), as of the end of our quarter ended March 31, 2018, our Chief Executive Officer and Principal Financial Officer determined that our controls were not adequate due to a lack of segregation of duties caused by limited accounting staff and resources which has impacted our ability to prevent or detect material errors in the financial statements including the implementation of new accounting standards. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis. Accordingly, based on this material weakness, our Chief Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures were not effective as of the end of the period covered by this Quarterly Report on Form 10-Q, March 31, 2018 as it relates to the timely implementation of the Company's review of key controls.

The Company plans on addressing this weakness by filling the consulting vacancy with professionals with experience in implementing a full review of key controls on an ongoing basis.

Changes in Internal Control over Financial Reporting

During the fiscal quarter ended March 31, 2018, there have been no changes in our internal control over financial reporting that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

Not applicable.

Item 1A. Risk Factors.

As a smaller reporting company, we are not required to provide the information under this Item.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None

Item 3. Defaults Upon Senior Securities.

Not applicable.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

Not applicable.

Item 6. Exhibits

2.1**	Mt. Emmons Mining Company Acquisition Agreement (incorporated by reference from Exhibit 2.1 to the Current Report on Form 8-K filed February 12, 2016)
3.1**	Restated Articles of Incorporation (incorporated by reference from Exhibit 4.1 to the Company's Registration Statement on Form S-3, [333-162607] filed October 21, 2009)
3.2**	Restated Bylaws, dated as of April 27, 2017 (incorporated by reference from Exhibit 3.1 to the Company's Form 10-Q filed May 19, 2017)
3.3**	Certificate of Designation for Series A Convertible Preferred Stock (incorporated by reference from Exhibit 3.1 to the Current Report on Form 8-K filed February 12, 2016)
3.4**	Articles of Amendment to Restated Articles of Incorporation (incorporated by reference from Exhibit 3.1 to the Company's Form 8-K filed June 21, 2016)
4.1**	Common Stock Purchase Warrant (incorporated by reference from Exhibit 4.1 to the Company's Report on Form 8-K filed December 22, 2016)
4.2**	Standstill Agreement, dated September 28, 2017, by and between U.S. Energy Corp. and APEG Energy II, L.P. (incorporated by reference from Exhibit 10.2 to the Company's Form 8-K filed October 5, 2017)
10.1(a)**	BNP Paribas– Credit Agreement (incorporated by reference from Exhibit 10.1 to the Company's Form 8-K filed August 2, 2010)
10.1(b)**	Wells Fargo Bank, National Association – Second Amendment to Credit Agreement (incorporated by reference from Exhibit 10.1 to the Company's Form 8-K filed July 25, 2013)
10.1(c)**	Wells Fargo Bank, National Association – Third Amendment to Credit Agreement (incorporated by reference from Exhibit 10.1 to the Company's Form 8-K filed July 16, 2015)
10.1(d)**	Wells Fargo Bank, National Association – Fourth Amendment to Credit Agreement (incorporated by reference from Exhibit 10.1 to the Company's Form 10-Q filed August 15, 2016)
10.1(e)**	APEG Energy II, L.P. – Fifth Amendment to Credit Agreement (incorporated by reference from Exhibit 10.1 to the Company's Form 8-K filed July 3, 2017)

10.1(f)**	BNP Paribas – Mortgage Agreement (incorporated by reference from Exhibit 10.2 to the Company's Form 8-K filed August 2, 2010)
10.1(g)**	Wells Fargo Bank, National Association – Guaranty (incorporated by reference from Exhibit 10.3 to the Company's Form 8-K filed August 2, 2010)
10.2**†	USE 2001 Officers' Stock Compensation Plan (incorporated by reference from Exhibit 4.21 to the Company's Annual Report on Form 10-K filed September 13, 2002)
10.3**†	2001 Incentive Stock Option Plan (amended in 2003) (incorporated by reference from Exhibit 4.2 to the Company's Annual Report on Form 10-K filed April 15, 2005)
10.4**	2008 Stock Option Plan for Independent Directors and Advisory Board Members (incorporated by reference from Exhibit 4.3 to the Company's Annual Report on Form 10-K filed March 13, 2009)
10.5**†	U.S. Energy Corp. Employee Stock Ownership Plan (incorporated by reference from Exhibit 4.1 to the Company's S-8 filed April 13, 2012)
10.6**†	Amended and Restated 2012 Equity and Performance Incentive Plan (incorporated by reference from Appendix A to the Company's Proxy Statement on Form DEF14A filed April 28, 2015)
10.6.1**	Form of Grant to the 2012 Equity and Performance Incentive Plan (incorporated by reference from Exhibit 10.5.1 to the Form 10-K filed March 18, 2013)
10.7**	Amendment Assignment and Assumption Agreement (Anfield Resources and Uranium One) dated as of August 14, 2014
10.8(a)**†	Executive Employment Agreement – Keith G. Larsen (effective 4-20-12) (incorporated by reference from Exhibit 10.1 to the Form 8-K filed January 17, 2012)
10.8(b)** †	Executive Employment Agreement – David Veltri (effective 10-23-15) (incorporated by reference from Exhibit 10.2 to the Form 10-Q filed August 15, 2016)
10.8(c)**†	Agreement and Mutual Release of All Claims – Keith G. Larsen (effective 9-25-15) (incorporated by reference from Exhibit 10.8(b) to the Form 10-K/A filed April 29, 2016)
10.8(d)**†	Agreement and Mutual Release of All Claims – Steven D. Richmond (effective 12-31-15) (incorporated by reference from Exhibit 10.8(c) to the Form 10-K/A filed April 29, 2016)
10.8(e)**†	Agreement and Mutual Release of All Claims – Bryon G. Mowry (effective 12-31-15) (incorporated by reference from Exhibit 10.8(d) to the Form 10-K/A filed April 29, 2016)
10.8(f)**†	Form of Executive Severance and Non-Compete Agreement (incorporated by reference from Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q filed on May 10, 2013)
10.8(g)** †	Executive Employment Agreement – Ryan Smith (effective 5-18-17) (incorporated by reference from Exhibit 10.1 to the Company's Form 8-K filed May 32, 2017)
10.8(h)** †	Agreement and Release by and among U.S. Energy Corp., Stephen Conrad, Thomas Bandy, Jerry Danni, James Fraser, and Leo Heath dated October 18, 2017 (incorporated by reference from Exhibit 10.8(h) to the Company's Annual Report on Form 10-K filed March 28, 2018)
10.8(i)**†	Form of Option Agreement between U.S. Energy Corp. and its directors (incorporated by reference from Exhibit 10.8(i) to the Company's Annual Report on Form 10-K filed March 28, 2018)
10.8(j)** †	Form of Incentive Option Agreement between U.S. Energy Corp. and its executive officers (incorporated by reference from Exhibit 10.8(j) to the Company's Annual Report on Form 10-K filed March 28, 2018)
10.8(k)** †	Form of Indemnity Agreement between U.S. Energy Corp. and its directors and officers (incorporated by reference from Exhibit 10.8(k) to the Company's Annual Report on Form 10-K filed March 28, 2018)
10.9**	Agreement for Purchase of Leasehold Interests in McKenzie and Williams Counties, North Dakota (Brigham Oil & Gas, L.P.) (incorporated by reference from Exhibit 10.6 to the Company's Annual Report on Form 10-K filed March14, 2012)
10.10(a)**	Agreement for Purchase of Leasehold Interests in McKenzie County, North Dakota (Geo Resources, Inc.) (incorporated by reference from Exhibit 10.7(a) to the Company's Annual Report on Form 10-K filed March14, 2012)
10.10(b)**	

	Amendments (5) to Agreement for Purchase of Leasehold Interest in McKenzie County, North Dakota (Geo Resources, Inc.) (incorporated by reference from Exhibit 10.7(b) to the Company's Annual Report on Form 10-K filed March14, 2012)
10.11(a)**	Participation Agreement between Energy One, LLC and Contango/Crimson effective February18, 2011 for the Leona River Project (incorporated by reference from Exhibit 10.10(a) to the Company's Annual Report on Form 10-K filed March 12, 2014)
10.11(b)**	Participation Agreement between Energy One, LLC and Contango/Crimson effective April 1, 2011 for the Booth/Tortuga Project (incorporated by reference from Exhibit 10.10(b) to the Company's Annual Report on Form 10-K filed March 12, 2014)
10.12**	Series A Convertible Preferred Stock Purchase Agreement (incorporated by reference from Exhibit 10.1 to the Current Report on Form 8-K filed February 12, 2016)
10.13**	Investor Rights Agreement (incorporated by reference from Exhibit 10.2 to the Current Report on Form 8-K filed February 12, 2016)

10.14**	Securities Purchase Agreement dated as of December 16, 2016 (incorporated by reference from Exhibit 10.1 to the Company's Report on Form 8-K filed December 22, 2016)
10.15**	Purchase and Sale Agreement, dated October 3, 2017, by and among U.S. Energy Corp., Energy One LLC and Statoil Oil and Gas LP (incorporated by reference from Exhibit 10.1 to the Company's Form 8-K filed October 10, 2017)
10.16**	Exchange Agreement, dated September 28, 2017, by and among U.S. Energy Corp., Energy One LLC, and APEG Energy II, L.P. (incorporated by reference from Exhibit 10.1 to the Company's Form 8-K filed October 5, 2017)
10.17**	Form of Common Stock Sales Agreement by and between U.S. Energy Corp. and Northland Securities Inc., dated January 5, 2018 (incorporated by reference from Exhibit 1.1 to the Company's Form 8-K filed January 5, 2018)
14.0**	Code of Ethics (incorporated by reference from Exhibit 14 to the Company's Annual Report on Form 10-K filed March 30, 2004)
16.1**	Letter of Hein & Associates LLP, regarding change in independent registered public accounting firm (incorporated by reference from Exhibit 16.1 to the Company's Form 8-K filed November 17, 2017)

31.1*	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes – Oxley Act of 2002
31.2*	Certification of principal financial officer pursuant to Section 302 of the Sarbanes – Oxley Act of 2002
32.1*	Certification under Rule 13a-14(b) of Chief Executive Officer
32.2*	Certification under Rule 13a-14(b) of Chief Financial Officer
101.INS	XBRL Instance Document
101.SCH	XBRL Schema Document
101.CAL	XBRL Calculation Linkbase Document
101.DEF	XBRL Definition Linkbase Document
101.LAB	XBRL Label Linkbase Document
101.PRE	XBRL Presentation Linkbase Document

* Filed herewith.

** Previously Filed

† Exhibit constitutes a management contract or compensatory plan or agreement.

In accordance with SEC Release 33-8238, Exhibits 32.1 and 32.2 are being furnished and not filed.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

		U.S. ENERGY CORP. (Registrant)
Date: May 14, 2018	By:	*/s/ David A. Veltri* DAVID A. VELTRI, Chief Executive Officer

U.S. ENERGY CORP. (Registrant)

Date: May 14, 2018 By:*/s/ Ryan L. Smith*
RYAN L. SMITH, Chief Financial Officer

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