Carbon Energy Corporation

Shareholder Report

June 30, 2023

Carbon Energy Corporation
June 30, 2023

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion includes forward-looking statements about our business, financial condition and results of operations, including discussions about management's expectations for our business. These statements represent projections, beliefs and expectations based on current circumstances and conditions, and you should not construe these statements either as assurances of performance or as promises of a given course of action. Instead, various known and unknown factors may cause our actual performance and management's actions to vary, and the results of these variances may be both material and adverse.

Carbon Energy Corporation (the "Company") is an independent exploration and production company engaged in the acquisition, development and production of oil and natural gas properties in the Ventura Basin of California through our majority-owned subsidiary, Carbon California Company, LLC ("Carbon California"). The Company owns 53.92% of the voting and profits interests of Carbon California which is consolidated for financial reporting purposes as a majority-owned subsidiary. Prudential Capital Energy Partners, L.P. or its affiliates (collectively, "PCEP") owns the remaining 46.08% of the voting and profits interests in Carbon California.

As of June 30, 2023, there were 2,089,739 common shares outstanding. Investor information is available on the Company's website at www.carbonenergycorp.com under "Investor Relations."

Appalachia Divestiture

On May 26, 2020, Carbon Energy Corporation, together with Nytis Exploration (USA) Inc. and certain of the Company's other direct and wholly owned subsidiaries, sold all of the issued and outstanding membership interests of Carbon Appalachia Company LLC and Nytis Exploration Company LLC to Diversified Gas & Oil Corporation ("DGO") for a purchase price of $125.0 million (the "Appalachia Divestiture").

In connection with the Appalachia Divestiture, a holder of preferential rights related to transfer of certain leases included in the divested assets made a total of nine allegations related to the transfer of the leases from the Company to DGO, as the seller and buyer, respectively. In May 2022, a trial occurred related to these allegations and the Company was found to be liable relating to one of the allegations and DGO was found to be liable of the balance of the allegations. A final judgment is pending. Both parties intend to appeal the outcome of the trial. The Company is not able to reasonably estimate its liability, if any, at this time. Depending on the outcome of the final judgment and appeals process, receipt of some or all of the escrow funds may be affected.

Operational Highlights

During 2023, we have concentrated our efforts on the development of our producing oil properties in Ventura County, California. Our field development activities have consisted principally of return to production and recompletion projects. We have focused on operating efficiencies, reduction of operating expenses, optimization and acquisition of natural gas gathering and compression facilities to create greater flexibility in transporting our production to markets with more favorable pricing, and the identification and permitting of development project opportunities to increase production, cash flow and reserves.

Carbon California Midstream

On February 13, 2023, Carbon California Midstream, LLC was formed as a wholly owned subsidiary of Carbon California Company. On February 15, 2023 and acquired, at no cost, midstream assets associated with the Company's production assets located in Ventura County, California.

Results of Operations

The following table sets forth, for the periods presented, selected historical unaudited condensed consolidated statements of operations and production data:

(in thousands, except production and per unit data)	Three Months Ended June 30, 2023 (unaudited)	Three Months Ended March 31, 2023 (unaudited)	Change	% Change
Revenue:				
Oil sales	$7,653	$6,140	$1,513	25%
Natural gas liquids	309	345	(36)	(10%)
Natural gas sales	491	2,191	(1,700)	(78%)
Total Revenue	$8,453	$8,676	($223)	(3%)
Expenses:				
Lease operating expenses	$3,340	$3,381	($41)	3%
Transportation costs	1,073	1,233	(160)	13%
Production and property taxes	373	345	28	(8%)
General and administrative	1,268	1,214	54	(4%)
Depreciation of property, plant and equipment	702	557	145	(26%)
Accretion of asset retirement obligations	168	165	3	(2%)
Loss on settlement of asset retirement obligations	317	(81)	398	n/a
Total Expenses	$7,241	$6,816	$425	(6%)
Operating income	$1,212	$1,860	($648)	(35%)
Other income and (expense):				
Interest expense	($1,466)	($1,432)	($34)	(2%)
Commodity derivative gain	$850	$1,645	($795)	(48%)
Total other income and (expense)	($617)	$213	($829)	n/a
Income before income taxes	$595	$2,073	($1,478)	(71%)
Net income before non-controlling interest	$595	$2,073	($1,478)	(71%)
Net income attributable to non-controlling interests*	$345	$1,028	($683)	(66%)
Net income attributable to controlling interests before preferred shares	$250	$1,045	($795)	(76%)
Net income attributable to preferred shares – preferred return	$75	$75	-	
Net income (loss) attributable to common shares	$175	$970	($795)	(82%)
Adjusted EBITDA**	$763	$1,013	($250)	(25%)

*Net income (loss) attributable to non-controlling interests represents Prudential's share of income (losses) in Carbon California Company, LLC

**Adjusted EBITDA is defined as Net income (loss) before non-controlling interest adjusted for Interest Income, Interest Expense, Depreciation, Impairment of PP&E, Non- cash stock-based comp, Accretion, Hedging unrealized gain/loss

(in thousands, except production and per unit data)	Three Months Ended June 30, 2023	Three Months Ended March 31, 2023	Change	% Change
Capital Expenditures				
Drilling and Development	$848	$884	($36)	4%
Operations Information:				
Oil production	101,706	78,623	23,083	29%
Natural gas production (Mcf)	152,668	112,240	40,428	36%
Natural gas liquids production (Bbl)	13,718	9,632	4,086	42%
Combined production (Mboe)	140,869	106,962	33,907	32%
Average prices before effects of hedges:				
Oil (per Bbl)	$75.25	$78.09	($2.84)	(4%)
Natural gas (per Mcf)	$3.21	$19.52	($16.31)	(84%)
Natural gas liquids (per Bbl)	$22.52	$35.77	($13.25)	(37%)
Combined (per Mboe)	$60.00	$81.11	($21.11)	(26%)
Average prices after effects of hedges*:				
Oil (per Bbl)	$62.21	$58.04	($4.17)	7%
Natural gas (per Mcf)	$3.21	$19.52	($16.31)	(84%)
Natural gas liquids (per Bbl)	$22.52	$35.77	($13.25)	(37%)
Combined (per Mboe)	$50.59	$66.37	($15.68)	(24%)
Average costs (per Mboe):				
Lease operating expenses	$23.71	$31.61	($7.90)	25%
Transportation costs	$7.62	$11.53	($3.91)	34%
Production and property taxes	$2.65	$3.22	($0.57)	18%
Cash-based general and administrative expenses	$8.58	$11.67	($3.09)	26%
Depreciation, depletion and amortization	$4.98	$5.21	($.0.23)	4%

*Includes effect of settled commodity derivative gains and losses

Management Discussion and Analysis

The following discussion and analysis relates to items that have affected our results of operations for the three months ended June 30, 2023 and March 31, 2023.

Oil, natural gas, and natural gas liquids sales – Sales of oil, natural gas, and natural gas liquids decreased approximately $223,000, for the three months ended June 30, 2023 compared to the three months ended March 31, 2023, primarily due to a decrease of commodity prices by approximately 26%.

Commodity derivative gain (loss) – We do not designate our commodity derivatives as cash flow hedges; therefore, they do not receive hedge accounting treatment and all mark-to-market gains or losses, as well as settlement gains or losses on the derivative instruments, are currently recognized in our results of operations. The unrealized gains and losses represent the changes in the fair value of these contracts as oil and natural gas futures prices fluctuate relative to the fixed price we will receive from these contracts. For the three months ended June 30, 2023 and March 31, 2023, we had hedging gains of approximately $850,000 and approximately $1.6 million, respectively. Our unrealized derivative gain or loss is primarily due to fair market value adjustments caused by market prices being lower or higher than our contracted hedged prices.

Lease operating expenses – Lease operating expenses decreased by $41,000, or 3%, for the three months ended June 30, 2023 as compared to the three months ended March 31, 2023, primarily due to a decrease in workover expenses during the second quarter of 2023.

Gathering and transportation costs– Transportation costs decreased by $160,000 for the three months ended June 30, 2023 as compared to the three months ended March 31, 2023, primarily due to a decrease in commodity sales.

Production and property taxes – Production and property taxes increased by $28,000 in the three months ended June 30, 2023 as compared to the three months ended March 30, 2023, primarily due to an increase in assessed value of property.

General and administrative ("G&A") – G&A increased by approximately $54,000 for the three months ended June 30, 2023 as compared to the three months ended March 31, 2023 primarily due to a cost of living adjustment resulting in an increase in salaries.

Liquidity and Capital Resources

Our primary sources of liquidity and capital resources are cash flows from operations. We may use other sources of capital, including the issuance of debt or equity securities or joint ventures to fund operations, acquisitions or maintain financial flexibility. Access to additional capital in the current environment is limited and the terms of any available capital may not be acceptable to the Company.

As of June 30, 2023, Carbon California's liquidity was $715,000, consisting of unrestricted cash on hand. As of June 30, 2023, the borrowing base on the Senior Notes was $40.0 million with $31.2 million drawn and outstanding. Effective December 31, 2021 through maturity on December 31, 2025, our senior lender may, but is not obligated, to make advances under the Senior Notes. Additionally, Carbon California's bond underwriter requires cash collateral in the form of letter(s) of credit, which accounts for $3.3 million of restricted cash as of June 30, 2023.

As of June 30, 2023, the Company had approximately $3.4 million in escrowed funds associated with the Appalachia Divestiture. Approximately $600,000 of these funds relate to employment-related obligations that are included in Accounts payable and accrued liabilities. The remaining $2.8 million escrow amounts are to be released to the Company upon satisfaction of certain indemnification obligations and release requirements over the 36 months following the closing of the Appalachia Divestiture. The receipt and timing of some or all of the remaining escrow funds may be affected by the outcome of the pending final judgment and any related appeals.

As a result of the delay in the release of the indemnification-related escrow funds, during the fourth quarter of 2022 the Company advanced $200,000 of escrow funds associated with the employment-related obligations to satisfy outstanding accounts payable and general corporate obligations. The Company intends to return these funds to the employment-related escrow as soon as practically possible.

Ongoing activities of Carbon Energy will be funded by a management fee of $1.5 million annually paid to the Company by Carbon California and by any proceeds released from escrow.

The relatively higher oil and natural gas price environment, Carbon California's relationship with its Senior Lender and its demonstrated ability to make operating and financial adjustments to a changing operating environment allow management to believe the Company is able to meet its financial obligations for the forthcoming 12-month period.

Senior Notes

Carbon California's Senior Notes are provided by Prudential Legacy Insurance Company of New Jersey and The Prudential Insurance Company of America. The maximum principal amount available under the Senior Notes is based upon the borrowing base attributable to Carbon California's oil and gas reserves which is determined at least semi-annually. As of June 30, 2023, the borrowing base of the Senior Notes was $40.0 million of which $31.2 million was outstanding. Effective December 31, 2021 through maturity on December 31, 2025, our senior lender may, but is not obligated, to make advances under the Senior Notes.

As of June 30, 2023, the effective borrowing rate for the Senior Notes was 11.66%. In addition, the Senior Notes include an annual administrative fee of $75,000.

The Senior Notes are secured by the assets of Carbon California and require Carbon California, as of January 1 and July 1 of each year, to hedge its forecast production for the following 12, 24 and 36 months at a rate of 75%, 65% and 50%, respectively.

Carbon California may at any time repay the Senior Notes, in whole or in part, without penalty. The Company is not a guarantor of the Senior Notes.

Subordinated Notes

On February 15, 2017, Carbon California entered into a Securities Purchase Agreement with PCEP for the issuance and sale of Subordinated Notes of $10.0 million due February 15, 2024, bearing interest of 12.0% per annum (the "the 2017 Subordinated Notes"). PCEP also received 1,425 Class A Units, representing a 5.0% profit sharing percentage in Carbon California.

On May 1, 2018, Carbon California entered into an agreement with PCEP for the issuance and sale of $3.0 million in subordinated notes due February 15, 2024, bearing interest of 12.0% per annum (the "2018 Subordinated Notes"). PCEP also received 585 Class A Units, representing a 2.0% profit sharing percentage in Carbon California.

The 2017 and 2018 Subordinated Notes (collectively, the "Subordinated Notes") require Carbon California, as of January 1 and July 1 of each year, to hedge its anticipated production at such time for the following 12, 24 and 36 months at a rate of 67.5%, 58.5% and 45.0%, respectively.

As of February 17, 2020, prepayment of the Subordinated Notes is not subject to a prepayment fee. The interest payable on the Subordinated Notes is able to be paid in kind at the election of Carbon California. An election to pay in kind results in the paid-in-kind interest to be added to the principal balance of the Subordinated Notes. The incremental principal as a result of the paid-in-kind interest bears an interest rate of 12%. A cash interest payment of approximately $490,000 was made in February of 2023. Interest of approximately $490,000 was paid in kind in May of 2023. The Company is not a guarantor of the Subordinated Notes.

Restrictions and Covenants

The Senior Notes and the Subordinated Notes contain affirmative and negative covenants that, among other things, limit Carbon California's ability to (i) incur additional debt; (ii) incur additional liens; (iii) sell, transfer or dispose of assets; (iv) merge or consolidate, windup, dissolve or liquidate; (v) make dividends and distributions on, or repurchases of, equity; (vi) make certain investments; (vii) enter into certain transactions with our affiliates; (viii) enter into sales-leaseback transactions; (ix) make optional or voluntary payments of debt; (x) change the nature of our business; (xi) change our fiscal year to make changes to the accounting treatment or reporting practices; (xii) amend constituent documents; and (xiii) enter into certain hedging transactions.

Amendments

In July 2020, Carbon California amended the Senior Notes and both the 2017 and 2018 Subordinated Notes to amend the total leverage ratio, senior leverage ratio and interest coverage ratio and to provide a waiver for non-compliance with Senior Notes EBITDA ratio as of March 31, 2020. Amendment to the Senior Notes restricted additional borrowings under the Senior Notes through December 31, 2020. Additionally, the interest payable under the Subordinated Notes, beginning May 15, 2020, would be paid in kind and added to the outstanding principal amount of each note through December 31, 2020.

In December 2020, Carbon California amended the Senior Revolving Notes and both the 2017 and 2018 Subordinated Notes to amend the total leverage ratio and senior leverage ratio, effective September 30, 2020 through December 31, 2021. Additionally, the Senior Revolving Notes were amended to require a $250,000 principal reduction each quarter beginning in the first quarter of 2021 until maturity in February 2022 and restricted additional borrowings under the Senior Notes through December 31, 2021.

In November 2021, Carbon California amended the Senior Notes and both the 2017 and 2018 Subordinated Notes to amend the total leverage ratio and senior leverage ratio and to provide a waiver for non-compliance with Senior Notes EBITDA ratios as of

September 30, 2021. Additionally, the Senior Revolving Notes were amended to require a) a $1.5 million principal reduction during the fourth quarter of 2021, b) a $1.0 million principal reduction during each quarter of 2022, c) an increase of 0.5% interest rate on borrowings, and d) a payment of excess cash flows, as defined, upon completion of the 2022 audited financial statements. The amendment provides for an eighteen-month extension of the Senior Notes, with a maturity date of May 15, 2023. Through maturity our senior lender may, but is not obligated, to make advances under the Senior Notes.

In March 2022, Carbon California amended the Senior Revolving Notes to allow for payment of the March 31, 2022 principal reduction payment in the amount of $1 million to be paid no later than April 30, 2022, which Carbon California timely paid in April 2022.

In February 2023, Carbon California created a new wholly owned subsidiary, Carbon California Midstream, LLC ("Carbon Midstream") and completed the acquisition of midstream assets associated with its production assets. Carbon California amended the Senior Revolving Notes and both the 2017 and 2018 Subordinated Notes to allow for the inclusion of Carbon Midstream within the entity's structure and Prudential's collateral. Additionally, the principal payment of $1.0 million due March 31, 2023 was extended until May 15, 2023.

In May 2023, the Senior Revolving Notes were amended to extend the maturity date of the Senior Revolving Notes until June 15, 2023.

In July 2023, the Company further amended the Revolver, the Subordinated Notes and the 2018 Subordinated Notes (collectively, "the Notes") to a) extend the maturity of the Revolver to December 31, 2025, b) extend the maturity of the Subordinated Notes and the 2018 Subordinated Notes to June 30, 2026, c) amend the total leverage ratio and senior leverage ratio beginning on June 30, 2023 through maturity, d) amend the Revolver to require minimum principal reduction payments beginning on March 31, 2024, e) replace LIBOR with SOFR (secured overnight financing rate) as the base index rate, f) increase the additional fixed rate component under the Revolver from 6.50% to 7.00%, and g) adjust minimum hedging requirements so as to not extend beyond the maturity date of the Revolver of December 31, 2025. In conjunction with the amendment of the Revolver, the Company incurred an amendment fee of approximately $153,000 that will be added to the outstanding principal of the Revolver on June 30, 2023.

Risk and Uncertainties

Financial results may continue to be uncertain. The changing macroeconomic and commodity price environment and uncertainty surrounding the extent of the impact of these events may result in continued direct and indirect impacts to the results of operations, liquidity, and cash flows. Estimates used in these consolidated financial statements are uncertain, and actual results may differ materially from amounts previously estimated.

Employee Retention Credit

The Employee Retention Credit ("ERC") under the CARES Act was enacted to encourage businesses to keep employees on their payroll. The refundable tax credit is available to an eligible employer whose business has been financially impacted by COVID-19. The Company has determined it is eligible for certain benefits for both 2021 and 2022 associated with the ERC, depending on IRS acceptance of the applications. Receipt of benefits associated with the ERC are expected to be received in 2023.

Commodity Derivatives

Changes in the market prices for oil and natural gas impact revenue, cash flow, profitability, access to capital and rate of growth. Carbon California employs an oil price hedging strategy to limit the effect of commodity price fluctuations on its cash flow and to comply with the requirements of our Senior and Subordinated Notes credit facilities.

As of June 30, 2023, the hedge agreements consisted of the following:

Carbon California Company

	Collars		Swaps	
Year	Brent Bbl	Weighted Average Price Range	Brent Bbl	Weighted Average Price Range
2023	85,100	$ 54.61 – 94.80	180,200	$ 49.20
2024	204,300	$ 45.58 – 92.36	--	--
2025	83,800	$ 55.00 – 97.25	--	--

Carbon Energy Corporation
Consolidated Balance Sheets
(000's)

	June 30, 2023 (unaudited)	March 31, 2023 (unaudited)
ASSETS		
Current assets:		
Cash	$ 615	$ 2,042
Restricted cash	6,743	6,741
Accounts receivable:		
Revenue	2,509	3,569
Joint interest billings and other	319	241
Prepaid expenses, deposits and other current assets	1,257	1,649
Total current assets	11,444	14,242
Due from related parties	294	105
Property and equipment, at cost:		
Oil & gas properties		
Proved, net	65,076	64,567
Unevaluated	1,616	1,616
Other property and equipment, net	685	715
	67,376	66,898
Right of use assets	328	365
Commodity derivative asset	259	-
Total non-current assets	67,964	67,263
Total assets	$ 79,701	$ 81,611
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$ 9,886	$ 10,093
Asset retirement obligations	2,235	1,847
Lease liability - current	145	200
Commodity derivative liability - current	2,761	6,572
Credit facilities and notes payable - current	-	30,735
Total current liabilities	15,028	49,446
Non-current liabilities:		
Lease liability - noncurrent	128	117
Commodity derivative liability - noncurrent	-	1,328
Asset retirement obligations	8,304	8,516
Notes payable	47,468	16,124
Total non-current liabilities	55,895	26,081
Stockholders' equity:		
Preferred stock	1	1
Common stock	21	21
Additional paid-in capital	89,306	89,280
Retained Earnings (Accumulated deficit)	(93,742)	(95,037)
Total Carbon stockholders' equity	(4,415)	(5,736)
Non-controlling interest	13,192	11,819
Total stockholders' equity	8,777	6,083
Total liabilities and stockholders' equity	$ 79,701	$ 81,611

Carbon Energy Corporation

Consolidated Statements of Operations

(0000's)

	Three months ended June 30, 2023 (unaudited)		Three months ended March 31, 2023 (unaudited)
Revenue:			
Oil sales	7,653	$	6,140
Natural gas sales	491		2,191
Natural gas liquids	309		345
Total revenue	8,453		8,676
Expenses:			
Lease operating expenses	3,340		3,381
Transportation costs	1,073		1,233
Production and property taxes	373		345
General and administrative	1,268		1,214
Depreciation of property, plant and equipment	702		557
Accretion of asset retirement obligations	168		165
Loss on settlement of asset retirement obligations	317		(81)
Total expenses	7,241		6,816
Operating income	1,212		1,860
Other income and (expense):			
Commodity derivative loss	850		1,645
Interest income	4		2
Interest expense	(1,470)		(1,434)
Total other expense/income	(617)		213
Income before income taxes	595		2,073
Net income before non-controlling interest	595		2,073
Net loss attributable to non-controlling interests	345		1,028
Net income attributable to controlling interests before preferred shares	250		1,045
Net income attributable to preferred shares – preferred return	75		75
Net income attributable to common shares	175		970

Carbon Energy Corporation
Consolidated Statements of Cash Flows
(000's)

		Six months ended June 30, 2023 (unaudited)
Funds provided by (used in) operating activities;		
Net (loss) income	$	2,668
Items not involving cash:		
Depreciation, depletion and amortization		1,259
Accretion of asset retirement obligations		333
Unrealized derivative (gain) loss		(5,397)
Gain/Loss on settlement of asset retirement obligations		(157)
Stock-based compensation expense		26
PIK interest		448
Amortization of debt issuance costs		203
Gain on debt extinguishment		(23)
Net change in:		
Accounts receivable		981
Prepaid expenses, deposits and other current assets		392
Accounts payable, accrued liabilities		(86)
Other long-term assets		38
Net cash provided by operating activities		434
Funds provided by (used in) investing activities:		
Development of properties and equipment		(1,738)
Net change in non-cash working capital related to investing activities		(121)
Adjusted acquisition and development of properties and equip		(1,857)
Net cash provided by investing activities		(1,859)
Net decrease in cash and restricted cash		(1,425)
Cash and restricted cash, beginning of period		8,783
Cash and restricted cash, end of period		7,358
Cash		615
Restricted Cash		6,743
Cash and restricted cash, end of period	$	7,358