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MILLER PETROLEUM INC  
Form 10-Q  
September 13, 2010

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

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the quarterly period ended July 31, 2010

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-34732

MILLER PETROLEUM, INC.  
-----

(Exact name of registrant as specified in its charter)

TENNESSEE  
-----

62-1028629  
-----

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer Identification No.)

3651 BAKER HIGHWAY, HUNTSVILLE, TN  
-----

37756  
-----

(Address of principal executive offices)

(Zip Code)

(423) 663-9457  
-----

(Registrant's telephone number, including area code)

N/A  
---

(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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period of time that the registrant was required to submit and post such files)  Yes  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 the definitions of "large accelerated filer," "accelerated filer" and "smaller

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reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
 Non-accelerated filer  Smaller reporting company   
 (Do not check if 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

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

| Title of Class | No. of Shares Outstanding at September 7, 2010 |
|----------------|--|
| Common Stock   | 33,434,838                                     |

MILLER PETROLEUM, INC.  
 FORM 10-Q  
 JULY 31, 2010  
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### CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

This report contains forward-looking statements. These forward-looking statements are subject to known and unknown risks, uncertainties and other factors which may cause actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. These forward-looking statements were based on various factors and were derived utilizing numerous assumptions and other factors that could cause our actual results to differ materially from those in the forward-looking statements. These factors include, but are not limited to:

- o the capital intensive nature of oil and gas development and exploration operations and our ability to raise adequate capital to fully develop our operations and assets,
- o our ability to perform under the terms of the Assignment Oversight Agreement with the Alaska DNR, including meeting the funding commitments of that agreement,

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- o fluctuating oil and gas prices and the impact on our results of operations,
- o our ability to secure an extension of the Susitna Basin Exploration License,
- o the impact of the global economic crisis on our business,
- o the impact of natural disasters on our Cook Inlet Basin operations,
- o the imprecise nature of our reserve estimates,
- o our ability to recover proved undeveloped reserves and convert probable and possible reserves to proved reserves,
- o the possibility that present value of future net cash flows will not be the same as the market value,
- o the costs and impact associated federal and state regulations,
- o changes in existing federal and state regulations,
- o our dependence on third party transportation facilities,
- o insufficient insurance coverage,
- o conflicts of interest related to our dealings with MEI,
- o cashless exercise provisions of outstanding warrants,
- o market overhang related to restricted securities and outstanding options, warrants and convertible notes, and
- o adverse impacts on the market price of our common stock from sales by the holders of our common stock and warrants purchased in recent private offerings.

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Most of these factors are difficult to predict accurately and are generally beyond our control. You should consider the areas of risk described in connection with any forward-looking statements that may be made herein or in our Annual Report on Form 10-K for the year ended April 30, 2010. Readers are cautioned not to place undue reliance on these forward-looking statements and readers should carefully review this report in its entirety. Except for our ongoing obligations to disclose material information under the Federal securities laws, we undertake no obligation to release publicly any revisions to any forward-looking statements, to report events or to report the occurrence of unanticipated events. These forward-looking statements speak only as of the date of this report, and you should not rely on these statements without also considering the risks and uncertainties associated with these statements and our business.

### OTHER PERTINENT INFORMATION

Unless specifically set forth to the contrary, when used in this report the terms the "Company," "we," "us," "ours," and similar terms refers to Miller Petroleum, Inc., a Tennessee corporation doing business as Miller Energy Resources and our subsidiaries, Miller Rig & Equipment, LLC, Miller Drilling TN, LLC and Miller Energy Services, LLC, East Tennessee Consultants, Inc., East Tennessee Consultants II, LLC, Miller Energy GP, LLC, and Cook Inlet Energy, LLC.

The information which appears on our web site at [www.millerenergyresources.com](http://www.millerenergyresources.com) is not part of this report.

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### PART 1 - FINANCIAL INFORMATION

#### ITEM 1. FINANCIAL STATEMENTS.

##### MILLER PETROLEUM, INC. SUMMARY FINANCIAL INFORMATION (UNAUDITED)

|  | For the Three<br>Months Ended<br>July 31,<br>2010 | For the Three<br>Months Ended<br>July 31,<br>2009 |
|--|---|---|
|  | -----   | -----   |
| Revenue                                |   |   |
| Oil and gas revenue .....              | \$ 4,791,179                                      | \$ 404,392  |
| Service and drilling revenue .....     | 409,068   | 123,228   |
|  | -----   | -----   |
| Total .....                            | 5,200,247   | 527,620   |
| Direct Expenses                        |   |   |
| Oil and gas .....                      | 2,304,107   | 24,044  |
| Service and drilling .....             | 495,747   | 244,500   |
| Depletion expense .....                | 1,576,848   | 117,434   |
|  | -----   | -----   |
| Total .....                            | 4,376,702   | 385,978   |
|  | -----   | -----   |
| Gross Profit .....                     | 823,545   | 141,642   |
| Selling, general and administrative .. | 2,766,673   | 652,391   |

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|                                     |             |           |
|-------------------------------------|-------------|-----------|
| Depreciation and amortization ..... | 413,824     | 111,727   |
| LOSS FROM OPERATIONS .....          | (2,356,952) | (622,476) |
| Total other income .....            | 2,613,292   | 693,911   |
| NET INCOME .....                    | \$ 682,907  | \$ 72,213 |

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MILLER PETROLEUM, INC.  
SUMMARY FINANCIAL INFORMATION  
(UNAUDITED)  
(continued)

|   | July 31,<br>2010<br>(Unaudited) | April 30,<br>2010 | January 31,<br>2010<br>(Unaudited) |
|---|---------------------------------|-------------------|------------------------------------|
|   | -----                           | -----             | -----                              |
| Cash .....  | \$ 472,543                      | \$ 2,750,841      | \$ 2,508,186                       |
| Cash, restricted .....                                      | 126,379                         | 126,064           | 131,499                            |
| Total Cash .....  | 598,922                         | 2,876,905         | 2,639,685                          |
| Oil and Gas Properties .....                                | 378,509,510                     | 376,216,621       | 371,725,938                        |
| Total Assets .....  | 500,921,122                     | 500,452,155       | 493,244,733                        |
| Total Current Liabilities .....                             | 6,053,165                       | 4,828,333         | 1,284,932                          |
| Total Long-term Liabilities .....                           | 217,331,590                     | 219,883,001       | 201,350,622                        |
| Total Stockholders' Equity .....                            | 277,536,367                     | 275,740,821       | 290,609,179                        |
| <br>  |                                 |                   |                                    |
| Total Gross Producing Oil Wells ...                         | 186                             | 188               | 196                                |
| Total Gross Producing Gas Wells ...                         | 323                             | 337               | 249                                |
| Total Gross Producing Wells.....                            | 509                             | 525               | 445                                |
| <br>  |                                 |                   |                                    |
| Gross Oil/Gas Lease/License Acreage                         | 634,219                         | 645,683           | 657,170                            |
| Net Oil/Gas Lease/License Acreage .                         | 597,224                         | 603,546           | 610,728                            |
| <br>  |                                 |                   |                                    |
| Total Proved Oil Reserves MBOE ....                         | 10.344 (1)                      | 10.344 (1)        | 9.578 (2)                          |
| Total Proved Gas Reserves MBOE ....                         | 0.910 (1)                       | 0.910 (1)         | 1.149 (2)                          |
| Total Proved, Probable, Possible<br>Oil Reserves MBOE ..... | 17.634 (1)                      | 17.634 (1)        | 16.602 (2)                         |
| Total Proved Probable, Possible<br>Gas Reserves MBOE .....  | 3.321 (1)                       | 3.321 (1)         | 2.652 (2)                          |

(1) Based on Reserve Reports dated April 30, 2010.

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- (2) Based on Reserve Reports dated April 30, 2009, June 8, 2009, June 18, 2009, October 31, 2009, and December 10, 2009
- (3) Based on Reserve Reports dated April 30, 2009, June 8, 2009, June 18, 2009 and October 31, 2009.

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MILLER PETROLEUM, INC.  
CONSOLIDATED BALANCE SHEETS

ASSETS

|   | July 31,<br>2010<br>Unaudited | April 30,<br>2010 |
|---|-------------------------------|-------------------|
|   | -----                         | -----             |
| CURRENT ASSETS                                  |                               |                   |
| Cash .....                                      | \$ 472,543                    | \$ 2,750,841      |
| Cash, restricted .....                          | 126,379                       | 126,064           |
| Accounts receivable, net .....                  | 1,444,047                     | 1,444,844         |
| Accounts receivable - related parties .....     | 45,573                        | 47,446            |
| Inventory .....                                 | 767,678                       | 521,639           |
| Prepaid expenses .....                          | 177,556                       | 275,610           |
|   | -----                         | -----             |
| Total Current Assets .....                      | 3,033,776                     | 5,166,444         |
| Fixed Assets .....                              | 116,953,563                   | 116,782,535       |
| Less: accumulated depreciation .....            | (2,375,580)                   | (1,961,756)       |
|   | -----                         | -----             |
| Net Fixed Assets .....                          | 114,577,983                   | 114,820,779       |
| OIL AND GAS PROPERTIES                          |                               |                   |
| (On the basis of successful efforts accounting) | 378,509,510                   | 376,216,621       |
| Land .....                                      | 526,500                       | 526,500           |
| Cash - restricted, long-term .....              | 2,070,445                     | 2,071,839         |
| Other assets .....                              | 2,202,908                     | 1,649,972         |
|   | -----                         | -----             |
| Total Other Assets .....                        | 4,799,853                     | 4,248,311         |
|   | -----                         | -----             |
| TOTAL ASSETS .....                              | \$500,921,122                 | \$500,452,155     |
|   | =====                         | =====             |

The accompanying notes are an integral part of these consolidated financial statements.

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MILLER PETROLEUM, INC.

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CONSOLIDATED BALANCE SHEETS

LIABILITIES AND STOCKHOLDERS' EQUITY

|  | July 31,<br>2010<br>Unaudited | April 30,<br>2010 |
|--|-------------------------------|-------------------|
|  | -----                         | -----             |
| CURRENT LIABILITIES  |                               |                   |
| Accounts payable - trade .....   | \$ 5,244,203                  | \$ 3,579,112      |
| Accrued expenses .....   | 440,570                       | 421,938           |
| Current derivative liability .....   | 326,950                       | 720,840           |
| Unearned revenue .....   | 41,442                        | 106,443           |
|  | -----                         | -----             |
| Total Current Liabilities .....  | 6,053,165                     | 4,828,333         |
| LONG-TERM LIABILITIES  |                               |                   |
| Deferred income taxes payable .....  | 184,367,963                   | 184,468,878       |
| Asset retirement liability .....   | 15,662,003                    | 15,662,002        |
| Long term derivative liability .....   | 14,196,880                    | 16,708,947        |
| Notes payable, related parties, net .....  | 2,219,323                     | 1,803,775         |
| Notes payable - other, net .....   | 885,421                       | 1,239,399         |
|  | -----                         | -----             |
| Total Long-term Liabilities .....  | 217,331,590                   | 219,883,001       |
|  | -----                         | -----             |
| Total Liabilities .....  | 223,384,755                   | 224,711,334       |
| STOCKHOLDERS' EQUITY   |                               |                   |
| Common stock, 500,000,000 shares authorized at<br>\$0.0001 par value, 33,389,383 and 32,224,894<br>shares issued and outstanding, respectively | 3,339                         | 3,223             |
| Additional paid-in capital .....   | 28,733,128                    | 27,620,605        |
| Retained earnings .....  | 248,799,900                   | 248,116,993       |
|  | -----                         | -----             |
| Total Stockholders' Equity .....   | 277,536,367                   | 275,740,821       |
|  | -----                         | -----             |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY ....  | \$500,921,122                 | \$500,452,155     |
|  | =====                         | =====             |

The accompanying notes are an integral part of these consolidated financial statements.

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|  | 2010         | 2009       |
|--|--------------|------------|
|  | -----        | -----      |
| REVENUES                                       |              |            |
| Oil and gas revenue .....                      | \$ 4,791,179 | \$ 404,392 |
| Service and drilling revenue .....             | 409,068      | 123,228    |
|  | -----        | -----      |
| Total Revenue .....                            | 5,200,247    | 527,620    |
| COSTS AND EXPENSES                             |              |            |
| Cost of oil and gas revenue .....              | 2,304,107    | 24,044     |
| Cost of service and drilling revenue .....     | 495,747      | 244,500    |
| Selling, general and administrative .....      | 2,766,673    | 652,391    |
| Depreciation, depletion and amortization ..... | 1,990,672    | 229,161    |
|  | -----        | -----      |
| Total Costs and Expenses .....                 | 7,557,199    | 1,150,096  |
|  | -----        | -----      |
| LOSS FROM OPERATIONS .....                     | (2,356,952)  | (622,476)  |
| OTHER INCOME (EXPENSE)                         |              |            |
| Interest income .....                          | 4,553        | 7,971      |
| Interest expense .....                         | (219,338)    | (12,869)   |
| Gain on derivative securities.....             | 2,905,957    | -          |
| Loan fees and costs.....                       | (90,380)     | (52,636)   |
| Loss on sale of equipment.....                 | -            | (9,755)    |
| Gain on sale of properties.....                | 12,500       | -          |
| Gain on acquisitions .....                     | -            | 761,200    |
|  | -----        | -----      |
| Total Other Income .....                       | 2,613,292    | 693,911    |
|  | -----        | -----      |
| NET INCOME BEFORE INCOME TAXES .....           | 256,340      | 71,435     |
| INCOME TAX BENEFIT.....                        | (426,567)    | (778)      |
|  | -----        | -----      |
| NET INCOME.....                                | \$ 682,907   | \$ 72,213  |
|  | =====        | =====      |
| INCOME PER SHARE                               |              |            |
| BASIC .....                                    | \$ 0.02      | \$ 0.00    |
| DILUTED .....                                  | \$ 0.02      | \$ 0.00    |
| WEIGHTED AVERAGE SHARES OUTSTANDING            |              |            |
| BASIC .....                                    | 32,835,722   | 17,271,639 |
| DILUTED .....                                  | 40,591,670   | 17,271,639 |

The accompanying notes are an integral part of these consolidated financial statements.



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|   | For the Three<br>Months Ended<br>July 31, 2010<br>----- | For the Three<br>Months Ended<br>July 31, 2009<br>----- |
|---|---|---|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>   |   |   |
| Net Income .....  | \$ 682,907  | \$ 72,213   |
| Depreciation, depletion and amortization .....  | 1,990,672   | 229,161   |
| Adjustments to Reconcile Net Loss to Net Cash<br>Provided (Used) by Operating Activities: |   |   |
| Loss (gain) on sale of equipment .....  | --  | 9,755   |
| Gain on acquisitions .....  | --  | (761,200)   |
| Derivative liability, net .....   | (2,905,957)   | --  |
| Prepaid offering cost .....   | --  | (99,037)  |
| Issuance of equity for compensation .....   | 515,891   | --  |
| Issuance of equity for financing costs .....  | --  | 38,624  |
| Changes in Operating Assets and Liabilities:  |   |   |
| Accounts receivable .....   | 2,670   | (67,342)  |
| Inventory .....   | (246,039)   | (143,251)   |
| Prepaid expense .....   | 98,054  | (97,613)  |
| Accounts payable .....  | 1,665,091   | 251,311   |
| Accrued expenses .....  | 18,633  | 191,309   |
| Unearned revenue .....  | (65,001)  | 5,653   |
| Income taxes payable .....  | (100,915)   | --  |
| Deferred interest .....   | --  | 616   |
| Other assets .....  | (275,076)   | --  |
|   | -----   | -----   |
| Net Cash Provided (Used) by Operating Activities  | 1,380,930   | (369,801)   |
|   | -----   | -----   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>   |   |   |
| Purchase of equipment and improvements .....  | (171,028)   | (25,892)  |
| Capital expenditures for oil and gas properties .....                                     | (3,869,738)   | (18,112)  |
| Sale of oil and gas properties .....  | --  | 25,000  |
| Proceeds from sale of equipment .....   | --  | 50,000  |
|   | -----   | -----   |
| Net Cash Provided (Used) by Investing Activities  | (4,040,766)   | 30,996  |
|   | -----   | -----   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>   |   |   |
| Payments on notes payable .....   | --  | (5,672)   |
| Deferred financing assets .....   | (46,290)  | --  |
| Proceeds from borrowing .....   | 350,000   | 235,266   |
| Proceeds from sale of stock, net .....  | --  | 119,000   |
| Cash acquired through acquisition .....   | --  | 203,993   |
| Exercise of equity rights .....   | 76,749  | --  |
| Restricted cash .....   | (315)   | 6,042   |
| Restricted cash non-current .....   | 1,394   | (166,372)   |
|   | -----   | -----   |
| Net Cash Provided by Financing Activities .....   | 381,538   | 392,257   |
|   | -----   | -----   |
| NET INCREASE (DECREASE) IN CASH .....   | (2,278,298)   | 53,452  |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD .....                                      | 2,750,841   | 46,566  |
|   | -----   | -----   |
| CASH AND CASH EQUIVALENTS, END OF PERIOD .....  | \$ 472,543  | \$ 100,018  |

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|  | =====      | =====      |
|--|------------|------------|
| CASH PAID FOR INTEREST .....                         | \$ 221,541 | \$ 87,526  |
| CASH PAID FOR TAXES .....                            | \$ --      | \$ --      |
| SUPPLEMENTAL DISCLOSURE OF NON CASH FINANCING ITEMS: |            |            |
| Financing costs from issuance of warrants and stock  | \$ --      | \$ 38,624  |
| Cash acquired through issuance of stock .....        | \$ --      | \$ 203,993 |
| Restricted cash acquired through issuance of stock   | \$ --      | \$ 196,682 |
| Net assets acquired through issuance of stock .....  | \$ --      | \$ 930,525 |
| Conversion of debt for equity .....                  | \$ 520,000 | \$ --      |
| Common stock issued for prepaid offering costs ..... | \$ --      | \$ 115,000 |

The accompanying notes are an integral part of these consolidated financial statements.

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### MILLER PETROLEUM, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

#### (1) ORGANIZATION AND DESCRIPTION OF BUSINESS

These consolidated financial statements include the accounts of Miller Petroleum, Inc. (the "Company") and the accounts of its subsidiaries, Miller Drilling TN, LLC, Miller Energy Services, LLC, East Tennessee Consultants, Inc. and East Tennessee Consultants II, LLC for the comparative periods ended July 31, 2010 and 2009. Miller Petroleum, Inc.'s subsidiaries Miller Energy GP, LLC and Cook Inlet Energy, LLC were included in the consolidation for the period ended July 31, 2010 only, since these subsidiaries started up subsequent to the three months ended July 31, 2009. All inter-company balances have been eliminated in consolidation.

The Company's principal business consists of oil and gas exploration, production and related property management in the Appalachian region of eastern Tennessee as well as in the Cook Inlet Basin of Alaska. The Company's corporate offices are in Huntsville, Tennessee. The Company operates as one reportable business segment, based on the similarity of activities.

Certain information and footnote disclosures normally included in the financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. It is suggested that these financial statements be read in conjunction with the Company's April 30, 2010 Annual Report on Form 10-K. The results of operations for the period ended July 31, 2010 are not necessarily indicative of operating results for the full year. In the opinion of management, all adjustments (consisting of only normal recurring accruals) considered necessary for a fair presentation have been included.

#### (2) ACCOUNTING POLICIES

##### RECLASSIFICATIONS

Certain reclassifications have been made to the prior period amounts presented to conform to the current period presentations.

##### PRINCIPLES OF CONSOLIDATION AND NON-CONTROLLING INTEREST

The consolidated financial statements include the accounts of the Company and

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its subsidiaries, all of which are wholly-owned at July 31, 2010 except for Miller Energy Income, 2009-A, LP("MEI"), which is controlled by the Company. The non-controlling ownership interests in the net income (loss) are reflected within non-controlling interests on the Company's consolidated statements of operations. The non-controlling interests in the assets and liabilities of MEI are reflected as a component of stockholders' equity on the Company's consolidated balance sheets. All material intercompany transactions have been eliminated.

### USE OF ESTIMATES

The preparation of the Company's consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities that exist at the date of the Company's consolidated financial statements, as well as the reported amounts of revenue and costs and expenses during the reporting periods. The Company's consolidated financial statements are based on a number of significant estimates, including the revenue and expense accruals, deferred tax assets and liabilities, depletion, depreciation and amortization, asset impairments, the probability of forecasted transactions and the allocation of purchase price to the fair value of assets acquired. Actual results could differ from those estimates.

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The natural gas industry principally conducts its business by processing actual transactions as much as 60 days after the month of delivery. Consequently, the most recent two months' financial results were recorded using estimated volumes and contract market prices. Differences between estimated and actual amounts are recorded in the following month's financial results. Management believes that the operating results presented for the three months ended July 31, 2010 represent actual results in all material respects.

### IMPAIRMENT OF LONG-LIVED ASSETS

The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If it is determined that an asset's estimated future cash flows will not be sufficient to recover its carrying amount, an impairment charge will be recorded to reduce the carrying amount for that asset to its estimated fair value if such carrying amount exceeds the fair value.

The review of the Company's oil and gas properties is done by determining if the historical cost of proved properties less the applicable accumulated depletion, depreciation and amortization and abandonment is less than the estimated expected undiscounted future cash flows. The expected future cash flows are estimated based on the Company's plans to continue to produce and develop proved reserves. Expected future cash flow from the sale of production of reserves is calculated based on estimated future prices. The Company estimates prices based upon current contracts in place, adjusted for basis differentials and market related information including published futures prices. The estimated future level of production is based on assumptions surrounding future prices and costs, field decline rates, market demand and supply and the economic and regulatory climates. If the carrying value exceeds the expected future cash flows, an impairment loss is recognized for the difference between the estimated fair market value (as determined by discounted future cash flows) and the carrying value of the assets.

The determination of oil and natural gas reserve estimates is a subjective process, and the accuracy of any reserve estimate depends on the quality of

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available data and the application of engineering and geological interpretation and judgment. Estimates of economically recoverable reserves and future net cash flows depend on a number of variable factors and assumptions that are difficult to predict and may vary considerably from actual results

Oil and gas properties are reviewed annually for impairment or whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment charges are recorded if conditions indicate the Company will not explore the acreage prior to expiration of the applicable leases or if it is determined that the carrying value of the properties is above their fair value. There were no impairments of oil and gas properties or unproved properties recorded by the Company for the three months ended July 31, 2010 and 2009.

### INVENTORY

Inventory consists primarily of crude oil in tanks and is carried at the lower of cost or market on a "FIFO" basis.

### RECENT ACCOUNTING PRONOUNCEMENTS

All issued, but not yet effective accounting pronouncements are determined to be not applicable or significant by management and once adopted is not expected to have a material impact on the financial position of the Company.

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### (3) SALE OF OIL AND GAS PROPERTIES AND EQUIPMENT PURCHASES

On June 13, 2008 we sold approximately 30,000 acres of oil and gas leases and eight drilled but not completed wells to Atlas America, LLC ("Atlas") for \$19.625 million. At that time Wind City Oil & Gas, LLC and related entities were paid \$10.6 million for 2.9 million shares of the Company's common stock, eight drilled but not completed gas wells, two producing gas wells, and a RD20 drilling rig and related equipment in settlement of all litigation between the parties.

On November 10, 2008, the Company finalized a drilling contract with Atlas Energy Resources, LLC, an affiliate of Atlas. This is a two year agreement that will utilize two of the Company's drilling rigs operating in the East Tennessee area of the Appalachian Basin. We acquired a 2007 COPCO Model RD III drilling rig and related equipment from Atlas to assist in drilling the wells. This rig has been mobilized to the site and has commenced drilling operations. The Company borrowed \$1,850,125, secured by a certificate of deposit, to purchase this drilling rig. As of January 31, 2010, the debt was paid in full.

After the sale was completed, the Company paid off all notes, all undisputed payables, transaction fees of \$600,000 to Cresta Capital/Consortium, and paid a transaction fee of \$300,000 and issued 2,500,000 shares of common stock valued at \$825,000 to Mr. Scott Boruff, a former associate of Cresta Capital. Mr. Boruff was subsequently hired effective August 1, 2008 as the new CEO of the Company (see Commitments note below). He is a son-in-law of Deloy Miller the former CEO and current Chairman of the Board of Directors. Cresta was also granted a warrant to purchase one million shares of the Company's common stock for \$1.00 per share for a period expiring three years after the grant date and cancelled the five million performance warrants that it held.

The net gain on this sale of oil and gas property transaction was \$11,715,570.

A third party interested in aforementioned sale of the oil and gas properties is contesting the sale, see the Litigation note below.

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### (4) PARTICIPANT RECEIVABLES AND RELATED PARTY RECEIVABLES

Participant and related party receivables consist of receivables contractually due from our various joint venture partners in connection with routine exploration, betterment and maintenance activities. Our collateral for these receivables generally consists of lien rights over the related oil producing properties at both July 31, 2010 and April 30, 2010.

The Company had an account receivable from a member of the Board of Directors, and his family, at July 31, 2010 and April 30, 2010 in the amounts of \$30,956 and \$29,950, respectively for work performed on oil and gas wells. This board member and his wife own partial interests in the oil and gas wells the Company also owns.

The Company had notes payable at and July 31, 2010 and April 30, 2010 of \$3,071,444 and \$2,721,444, respectively, to MEI. MEI's general partner is Miller Energy GP, LLC, a 100% owned subsidiary of the Company.

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### (5) FIXED ASSETS

Fixed assets consist of the following:

|                                    | July 31,<br>2010 | April 30,<br>2010 |
|------------------------------------|------------------|-------------------|
|                                    | -----            | -----             |
| Machinery & Equipment .....        | \$ 4,768,658     | \$ 4,620,219      |
| Pipelines .....                    | 17,000,000       | 17,000,000        |
| Oil platform .....                 | 6,000,000        | 6,000,000         |
| Vehicles .....                     | 1,418,414        | 1,402,094         |
| Buildings .....                    | 87,682,810       | 87,682,810        |
| Office Equipment .....             | 83,681           | 77,411            |
|                                    | -----            | -----             |
|                                    | 116,953,563      | 116,782,534       |
| Less: accumulated depreciation ... | (2,375,580)      | (1,961,755)       |
|                                    | -----            | -----             |
| Net Fixed Assets .....             | \$ 114,577,983   | \$ 114,820,779    |

The increase in Machinery and Equipment primarily resulted from purchase of a rig. The increase in vehicles resulted from the purchase of two used trucks. The increase in office equipment primarily resulted from the purchase of new accounting software and new computers. Depreciation expense for the three months ended July 31, 2010 and 2009 was \$413,824 and \$111,727 respectively.

### (6) DERIVATIVE LIABILITIES

Effective May 1, 2009, the Company adopted the provisions of EITF 07-05 "Determining Whether an Instrument (or Embedded Feature) is Indexed to a Company's Own Stock," which was codified into ASC Topic 815 - Derivatives and Hedging. ASC 815 applies to any freestanding financial instruments or embedded features that have characteristics of a derivative and to any freestanding financial instruments that are potentially settled in an entity's own common stock. The Company has 4,016,715 of warrants with exercise reset provisions, which are considered freestanding derivative instruments. ASC 815 requires these warrants to be recorded as liabilities as they are no longer afforded equity treatment. The derivative liability as of July 31, 2010 and April 30, 2010 of \$14,523,830 and \$17,429,787, respectively is comprised of three transactions, 3,000,000 warrants issued in the current and past years, which are subject to an ongoing litigation matter, 716,715 warrants issued in an equity financing in

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March 2010 and 300,000 warrants issued pursuant to a consulting arrangement in March 2010. The terms of the exercise reset provision on the 716,715 warrants expire in September 2010, hence the related fair value of this derivative of \$326,950 has been recorded as a current liability. The Company utilized the Black-Scholes pricing model with the following weighted average assumptions: risk free rates from 1.47% to 2.42%, expected life terms ranging from .42 years to 2.5 years, an expected volatility range of 49% to 145% depending on the term of such equity contracts and a dividend rate of 0.0%. The fair value of the warrants issued and outstanding at May 1, 2009, attributed to this derivative liability has been determined to be immaterial due to the low stock price in comparison to the exercise price, hence there was no adjustment to make upon adoption of this accounting standard. During the three months ended July 31, 2010, the Company has recorded non-cash gains of \$2,905,957 relating to the change in fair value of these derivative instruments.

### Additional Fair Value Language

The accounting guidance establishes a fair value hierarchy based on whether the market participant assumptions used in determining fair value are obtained from independent sources (observable inputs) or reflect the Company's own assumptions of market participant valuation (unobservable inputs). A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The accounting guidance establishes three levels of inputs that may be used to measure fair value:

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- o Level 1--Quoted prices in active markets that are unadjusted and accessible at the measurement date for identical, unrestricted assets or liabilities;
- o Level 2--Quoted prices for identical assets and liabilities in markets that are inactive; quoted prices for similar assets and liabilities in active markets or financial instruments for which significant inputs are observable, either directly or indirectly; or
- o Level 3--Prices or valuations that require inputs that are both unobservable and significant to the fair value measurement.

The Company considers an active market to be one in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis, and views an inactive market as one in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers. Where appropriate the Company's or the counterparty's non-performance risk is considered in determining the fair values of liabilities and assets, respectively.

The fair value of our financial instruments at July 31, 2010 and April 30, 2010 follows:

|             | Fair Value Measurements at Reporting Date Using                                     |   |  |
|-------------|---|---|--|
| Description | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|             |   |   |  |

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|   |       |       |               |
|---|-------|-------|---------------|
| Derivative securities -<br>April 30, 2010 ..... | \$ -- | \$ -- | \$ 17,429,787 |
|   | ===== | ===== | =====         |
| Derivative securities -<br>July 31, 2010 .....  | \$ -- | \$ -- | \$ 14,523,830 |
|   | ===== | ===== | =====         |

(7) LONG-TERM DEBT

The Company had the following debt obligations at July 31, 2010 and April 30, 2010:

|  | July 31,<br>2010 | April 30,<br>2010 |
|--|------------------|-------------------|
|  | -----            | -----             |
| 6% convertible secured promissory notes, secured by<br>35,235 lease acreage, bearing interest at 6.00%,<br>due December 4, 2016 .....  | \$ 1,185,000     | \$ 1,705,000      |
| Secured promissory notes, secured by certain<br>equipment, bearing interest at 12%, due<br>November 1, 2013 and December 1, 2013 ..... | 3,071,444        | 2,721,444         |
|  | -----            | -----             |
| Total Notes Payable .....  | 4,256,444        | 4,426,444         |
| Less current maturities on other notes payable   | --               | --                |
| Less debt discount .....   | (1,151,700)      | (1,383,271)       |
|  | -----            | -----             |
| Notes Payable - Long-term .....  | \$ 3,104,744     | \$ 3,043,173      |
|  | =====            | =====             |

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In December 2009, the Company raised \$2,855,000 as 6% convertible secured promissory notes. These convertible secured notes bear interest at 6% per annum and mature in December 2016. The convertible secured notes, including any accrued and unpaid interest are convertible into common stock at \$.55 per share, at the option of the holder. The conversion price was below market at the time of this debt raise, as a result the fair value of beneficial conversion feature was computed to be \$809,263. This beneficial conversion feature was recorded as a debt discount and is being amortized over the term of the debt. The amortization expense recorded for the quarter ended July 31, 2010 was \$38,710.

On November 1, 2009, December 15, 2009 and May 15, 2010 MEI, a controlled entity of the Company, extended loans, as amended, of \$2,365,174, \$356,270, and \$350,000 respectively, totaling \$3,071,444 to the Company. These loans bear interest at a rate of 12% per year and are due in four years. These loans require monthly payments of interest only, with the principal due at the maturity date. The Company provided oil and gas drilling equipment as collateral for the loan. The Company issued 1,329,250 shares of common stock and 1,329,350 warrants to purchase common stock at an exercise price of a \$1.00. These common shares and warrants issued had a fair value of \$1,048,765, which have been recorded as a debt discount to be amortized over 48 months the term of such debt. Amortization expense of the debt discount costs for the quarter ended July 31, 2010 was \$65,548.

ASC 410-20 "Accounting for Asset Retirement Obligations" addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This

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statement requires companies to record the present value of obligations associated with the retirement of tangible long-lived assets in the period in which it is incurred. The liability is capitalized as part of the estimated costs to capitalize a well and site remediation once a well is abandoned. Over time, accretion of the liability is recognized as an operating expense and the capitalized cost is depreciated over the expected useful life of the related asset. The changes in the Company's liability for the periods ended April 30, 2009 and July 31, 2010 are as follows:

|   |               |       |
|---|---------------|-------|
| Asset retirement obligation as of April 30, 2010 .. | \$ 15,662,003 |       |
| Changes for 2011 .....                              | -             | ----- |
|   |               |       |
| Asset retirement obligation as of July 31, 2010 ... | \$ 15,662,003 |       |

### (8) STOCKHOLDERS' EQUITY

During the three months ended July 31, 2010, we issued the following securities: 1,164,489 shares, which included four warrant holders who exercised warrants for 177,600 shares in a cashless exercise that netted them 142,286 shares and three other warrant holders exercised warrants for 76,750 shares for an exercise price of \$1.00. In addition, nine note holders converted \$520,000 of their 6% secured convertible notes at a conversion rate of \$0.55 and were issued 945,453 shares. The Company also issued 3,100,000 employee and director options between February 18, 2010 and July 29, 2010 which created compensation expense of \$515,891 for the 3 months ended July 31, 2010.

The Company presents "basic" earnings (loss) per share and, if applicable, "diluted" earnings per share pursuant to the accounting guidance issued by the FASB. The calculation of diluted earnings per share is similar to that of basic earnings per share, except that the denominator is increased to include the number of additional common shares that would have been outstanding if all potentially dilutive common shares, such as those issuable upon the exercise of stock options and warrants, were issued during the period.

As of July 31, 2010 the exercise price of warrants and options below market value were \$10,277,796, and therefore there are dilutive effects of the common stock equivalents for the outstanding vested stock options and warrants for the three months ended July 31, 2010.

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### (9) STOCK OPTIONS AND WARRANTS

We record share-based payments at fair value and record compensation expense for all share-based awards granted, modified, repurchased or cancelled after the effective date, in accord with FASB guidance for "Share-Based Payments". We record compensation expense for outstanding awards for which the requisite service had not been rendered as of the effective date over the remaining service period.

We estimated the fair value of options and warrants granted during the three months ended July 31, 2010 and 2009 on the date of grant, using the Black-Scholes pricing model with the following assumptions:

|  | 2010<br>----- | 2009<br>----- |
|--|---------------|---------------|
| Weighted average of expected risk-free interest rates (Approximate 3 year Treasury Bill rate) .... | 2.21%         | 1.49%         |
| Expected years from vest date to exercise date .....   | 3.0           | 2.5           |
| Expected stock volatility .....  | 50-216%       | 371-391%      |



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Expected dividend yield ..... 0% 0%

The Company has adopted the FASB guidance, "Share Based Payments" FASB ASC 718-10. This guidance requires companies to expense the value of employee stock options and similar awards and applies to all outstanding and vested stock-based awards. In computing the impact, the fair value of each option is estimated on the date of grant based on the Black-Scholes options-pricing model utilizing certain assumptions for a risk free interest rate; volatility; and expected remaining lives of the awards. The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment.

As a result, if factors change and the Company uses different assumptions, the Company's stock-based compensation expense could be materially different in the future. In addition, the Company is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. In estimating the Company's forfeiture rate, the Company analyzed its historical forfeiture rate, the remaining lives of unvested options, and the amount of vested options as a percentage of total options outstanding.

If the Company's actual forfeiture rate is materially different from its estimate, or if the Company reevaluates the forfeiture rate in the future, the stock-based compensation expense could be significantly different from what we have recorded in the current period.

The Company recorded \$515,891 and \$0 of compensation expense, net of related tax effects, relative to stock options and warrants for the three months ended July 31, 2010 and 2009, respectively in accordance with the FASB guidance. Net loss per share basic for this expense is \$0.02 and \$0.00 and net loss per share diluted for this expense is \$0.01 and \$0.00.

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of our common stock for those awards that have an exercise price currently below the closing price. During the three months ended July 31, 2010 and 2009, the aggregate intrinsic value of stock options and warrants outstanding was \$4,132,221 and \$0, respectively.

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A summary of the stock options and warrants as of July 31, 2010 and 2009 and changes during the periods is presented below:

|   | Three months ended<br>July 31, 2010  |                                       | Three months ended<br>July 31, 2009  |                                       |
|---|--------------------------------------|---------------------------------------|--------------------------------------|---------------------------------------|
|   | Number of<br>Options and<br>Warrants | Weighted<br>Average<br>Exercise Price | Number of<br>Options and<br>Warrants | Weighted<br>Average<br>Exercise Price |
| Balance at April 30                     | 12,306,305                           | \$ 1.50                               | 4,090,000                            | \$ 0.88                               |
| Granted .....                           | 325,000                              | 5.13                                  | 120,000                              | 1.15                                  |
| Exercised .....                         | 219,036                              | 1.29                                  | -                                    | -                                     |
| Expired .....                           | -                                    | -                                     | -                                    | -                                     |
| Cancelled .....                         | 135,314                              | 1.00                                  | -                                    | -                                     |
| Balance at July 31                      | 12,276,955                           | 2.49                                  | 4,210,000                            | 0.88                                  |
| Options exercisable<br>at July 31 ..... | 6,739,455                            | \$ 1.53                               | 3,960,000                            | \$ 0.92                               |

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The following table summarizes information concerning stock options and warrants outstanding and exercisable at July 31, 2010:

| Options and Warrants Outstanding |                    |   | Options and Warrants Exercisable |                    |                                 |
|----------------------------------|--------------------|---|----------------------------------|--------------------|---------------------------------|
| Range of Exercise Price          | Number Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price  | Number Exercisable | Weighted Average Exercise Price |
| \$0.01 to 0.69                   | 2,080,000          | 2.9   | \$ 0.31                          | 1,892,500          | \$ 0.31                         |
| 1.00 to 1.82                     | 4,779,900          | 3.2   | 1.08                             | 3,279,900          | 1.11                            |
| 2.00 to 2.52                     | 1,750,000          | 3.9   | 2.13                             | 750,000            | 2.30                            |
| 4.98 to 6.94                     | 3,667,055          | 17.7  | 5.74                             | 817,055            | 5.28                            |
|                                  | 12,276,955         | 7.6   | \$ 2.49                          | 6,739,455          | \$ 1.53                         |
|                                  |                    |   |                                  |                    |                                 |

### (10) INCOME TAX

The Company operates several oil and gas wells in Alaska and has leased properties for other oil and gas exploration purposes. Alaska has investment tax incentives whereby through June 30, 2010, up to 20% of certain qualified expenditures are reimbursable via a tax credit which can be sold to other oil and gas companies at a discount to obtain an immediate realization of such benefits or such tax credits could be utilized by the Company to offset taxes due or obtain a refund based on certain future reinvestment criteria. Effective July 1, 2010, the state of Alaska has increased the tax incentive rate from 20% to 40% and relaxed the criteria for a refund requirement to be obtained from the state of Alaska. The Company has recorded a total of \$1,603,358 in other assets for an estimate of an investment tax credit incentive refund due from the state of Alaska, as of July 31, 2010, of which \$496,358 was recorded during the three months ended July 31, 2010.

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### (11) COMMITMENTS

On August 6, 2008 the Board of Directors employed Scott M. Boruff as CEO of the Company. The employment contract, as amended, provided for the following compensation:

- o Base salary of \$250,000 per annum, with provision for cost-of-living increases.
- o Options to purchase 250,000 shares of the Company's common stock at an exercise price per share of \$0.33, with vesting in equal annual installments over a period of four years.
- o A restricted stock grant of 250,000 shares of common stock, with vesting in equal annual installments over a period of four years.
- o Incentive Compensation - For each year of the employment term, (i) cash up to 100% of base salary and (ii) up to 100,000 shares of restricted common stock, in both instances based upon, and subject to, two performance benchmarks, gross revenue and EBITDA. One half of each element of incentive compensation is earned if the gross revenue benchmark is achieved, and the other half of

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each element is earned if the EBITDA benchmark is achieved.

In August 2008 we engaged a broker-dealer and member of FINRA which is a related party, to assist us in raising capital by means of a private placement of securities. As initial compensation for their services, we paid the firm a \$25,000 retainer, issued the firm's assigns 250,000 shares of our common stock, valued at \$115,000 and agreed to pay a monthly consulting fee of \$5,000. Upon the successful completion of the private offering we will be obligated to pay the firm certain cash compensation and issue them up to an additional 150,000 shares of our common stock in amounts to be determined based upon the gross proceeds received by us from the financing.

On December 10, 2009, the Company appointed Ford F. Graham as Vice-Chairman of the Board of Directors of Miller and as President of the Company. Mr. Graham received a signing bonus of \$200,000, an annual initial salary of \$200,000 and initial stock warrants to purchase 1,000,000 shares of Company stock which exercise prices ranging from \$0.01 to \$2.00. Mr. Graham resigned from these positions in June, 2010.

On December 10, 2009, the Company appointed David M. Hall as Director of the Company and Chief Executive Officer of the Company's Alaska subsidiary, Cook Inlet Energy, LLC. Mr. Hall is compensated at an annual initial salary of \$195,000 and has a three year employment agreement. In addition, the Company employed Walter J. Wilcox II and Troy Stafford, with three-year employment agreements to assist Mr. Hall. These gentlemen are currently being compensated under an oral agreement, however, the Company intends to enter into written employment agreements in the immediate future under the same terms and conditions. In May 2010, Mr. Stafford left the employ of Cook Inlet Energy, LLC.

On November 1, 2009 and on December 15, 2009, and May 15, 2010 MEI a controlled entity of the Company, extended loans, as amended, of \$2,365,174 and \$356,270 and \$350,000, respectively, totaling \$3,080,444 to the Company. These loans bear interest at the rate of 12% per year and are due in four years. These loans require monthly payments of interest only, with the principal due at the maturity date. The Company provided oil and gas drilling equipment as collateral for the loan. The Company issued 1,329,250 shares of common stock and 1,329,350 warrants to purchase common stock at an exercise price of a \$1.00. These common shares and warrants issued had a fair value of \$1,048,765, which have been recorded as a debt discount to be amortized over 48 months the term of such debt.

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In addition the Company incurred \$619,358 of finance costs of professional fees and commissions paid to raise such monies for MEI, as a result these monies are being amortized as deferred financing costs over the term of such debt of 48 months. Amortization expense of the deferred finance costs for the quarter ended July 31, 2010 was \$38,710. Amortization expense of the debt discount costs for the quarter ended July 31, 2010 was \$65,548.

### (12) LITIGATION

CNX Gas Company, LLC commenced litigation on June 11, 2008 in the Chancery Court of Campbell County, State of Tennessee in a case style CNX Gas Company, LLC vs. Miller Petroleum Inc., Civil Action No. 08-071, to enjoin us from assigning or conveying certain leases described in the Letter of Intent signed by CNX and our company on May 30, 2008, to compel us to specifically perform the assignments as described in the Letter of Intent; and for damages. A Notice of Lien Lis Pendens was issued June 11, 2008. We moved for entry of summary judgment dismissing the claims asserted against us by CNX and on January 30, 2009 the court found that CNX's claims had no merit. The court granted our motion and dismissed all claims

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asserted by CNX in that action. CNX has appealed the ruling, and briefs have been submitted to the Court of Appeals of Tennessee. Oral arguments were held on May 18, 2010, and an opinion from the Court of Appeals is expected sometime in the fall of 2010.

On May 20, 2009 Gunsight Holdings, LLC, a Florida limited liability company, filed a complaint in the United States District Court for the Eastern District of Tennessee, Northern Division, against us styled Gunsight Holdings, LLC, Plaintiff, v Miller Petroleum, Inc. and Ky-Tenn Oil, Inc., Defendants, Case No. 3-09-CV-221. The litigation surrounds certain rights related to approximately 6,800 acres in Scott County, Tennessee which KTO purportedly acquired under a lease assignment from an unrelated party in August 2004. In September 2008, KTO assigned us 75% of its interest in the subject lease and the working interest in all the wells on the leased land, retaining a 25% interest in the wells consisting of landowner's royalty and overriding royalty. On June 8, 2009 we acquired certain assets from KTO including KTO's undivided interest in approximately 170 oil and gas wells in Morgan, Scott and Fentress counties in Tennessee, together with all property, fixtures and improvements, leasehold interest and contract rights related to these wells and undivided interest in approximately 35,325 acres of oil and gas leases in Scott and Morgan counties, Tennessee. The lease which is the subject of the litigation was included in the assets purchased by us from KTO. The plaintiff is alleging that our company and KTO have failed or refused to pay royalties due to the plaintiff's predecessors and have breached the implied duty of further exploration by failing to drill required wells, failing to reasonably develop or explore the property, failing to maintain an active interest in further development of the property and otherwise failing to act as a prudent operator of the property thereby causing damages to the plaintiff exceeding \$75,000. The plaintiff is seeking a declaratory judgment of its allegations, removal of our company and KTO from the property, a full accounting of activities related to the property and all monies received from those activities, damages and costs of action. We have filed an answer denying the various claims and asserting affirmative defenses including that there has been continuous production from the subject lease. We are currently in discovery.

On October 8, 2009 we filed an action styled Miller Petroleum, Inc. v. Maynard, Civil Action No. 9992 in the Chancery Court for Scott County, Tennessee, seeking a declaratory judgment that there has been continuing commercial production of oil, and oil and gas lease owned by us is still in full force and effect. The defendant filed an Answer and Counterclaim, seeking in the Counterclaim a declaration that the oil and gas lease has expired. Although no compensatory monetary damages have been sought against us, the Counterclaim does seek attorney fees, expenses and costs. There has been no discovery to date and a trial date has not been assigned. Plaintiff's attorney left his firm, and the case has been delayed as plaintiff's new counsel (with the same firm) becomes familiar with the case.

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On March 26, 2010, Petro Capital III, LP filed an action styled Petro Capital III, LP v. Miller Petroleum, Inc., Civil Action No. 3:10-cv-00606P in the United States District Court for the Northern District of Texas, Dallas Division, seeking damages for breach of contract; damages for alleged negligent misrepresentation; a declaratory judgment regarding the proper number of and exercise price of the original warrants to which Petro Capital is entitled under a warrant and registration rights agreement, the number of penalty warrants to which Petro Capital may be entitled under a warrant and registration rights agreement, as well as the proper exercise price thereof, and damages resulting from the alleged breach of contract; and attorney's fees. On April 6, 2010, Petro Capital filed an Amended Complaint that did not include additional causes of action. We filed an Answer and Counterclaim on April 28, 2010. The

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Counterclaim seeks a declaratory judgment to declare void the issuance of any penalty warrants after May 4, 2007 (the latest date upon which the shares underlying the warrants would become freely tradable under Rule 144). The Counterclaim further seeks a declaratory judgment as to the number of shares and proper exercise price for the original warrant.

We are also party to various routine legal proceedings arising in the ordinary course of our business. Management believes that none of these actions, individually or in the aggregate, will have a material adverse effect on our financial condition or results of operations.

### (13) SUBSEQUENT EVENTS

In August 2010, two of our note holders converted \$25,000 of their 6% secured convertible notes at a conversion rate of \$0.55 and were issued 45,455 shares.

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

We are an independent exploration and production company that utilizes seismic data, and other technologies for geophysical exploration and development of oil and gas wells in the Appalachian region of eastern Tennessee and the Cook Inlet Basin in south central Alaska. In addition to our engineering and geological capabilities, we provide land drilling services on a contract basis to customers primarily engaged in natural gas exploration and production.

During fiscal 2009 and 2010, we completed several transactions which we believe had both a positive impact on our balance sheet and will assist us in our continued growth. These transactions, which are described in detail in our Annual Report for fiscal year 2010, included the following:

- o sale of leases and wells to Atlas Energy Recourses, LLC,
- o settlement of Wind City litigation,
- o acquisition of assets from Ky-Tenn Oil, Inc. ("KTO"),
- o acquisition of East Tennessee Consultants, Inc. ("ETC") and East Tennessee Consultants, LLC ("LLC"),
- o acquisition of Cook Inlet Energy LLC in Alaska, and
- o acquisition of Alaskan assets of Pacific Energy Resources.

As a result of these acquisitions, we presently have approximately 634,219 acres of gross oil and gas leases and exploration license rights (597,224 net acres), which includes 471,474 acres under the Susitna Basin Exploration License. The terms of these new leases have a net revenue interest ranging from 0.1% to 100% and run from three to five years. We are presently reviewing these leases, as well as our other existing leases, to determine the capital requirements and timing for drilling additional wells. During the three months ended July 31, 2010, we began reworking two of our Alaska wells and capitalized approximately \$3.9 million of costs associated with those efforts. In addition, we plan to drill five new wells in the next nine to 12 months. However, this is dependent upon the availability of additional capital. As a part of our fiscal 2008 sale to Atlas Energy, we retained a 5% royalty interest on a 1,930 acre tract that we expect to be the subject of Atlas Energy drilling. With the closing of these transactions, our management is now focusing the majority of its efforts on growing our company. In addition to raising capital we are also continuing to

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focus our short-term efforts on three distinct areas, including the following:

- o continuing to increase our overall oil and gas production through maintenance and repairs of nonperforming or underperforming wells,
- o organically growing production through drilling for our own benefit on existing leases and under license rights, leveraging our 100,000 plus well log database and over 600,000 acres which are either under lease or part of the Susitna Basin Exploration License, with a view towards retaining the majority of working interest in the new wells, and
- o expanding our contract drilling and service capabilities and revenues, including drilling and service contracts with third parties.

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Our ability, however, to implement one or more of these goals in a timely manner is dependent upon the availability of additional capital. To fully expand our operations as set forth above, we will need up to \$75 million to \$100 million to fund the balance of our expansion plans, including up to approximately \$67.4 million associated with obligations arising from our purchase of the Alaskan assets. To provide the required capital, we are seeking to leverage our existing assets as well as raise additional capital through the sale of equity and/or debt securities. We do not have any firm commitments for the additional capital we need to fully fund our operations and there are no assurances the capital will be available to us upon terms acceptable to us, if at all. While we are actively seeking to secure the additional capital, terms of the Securities Purchase Agreement for the March 2010 private offering contains restrictive covenants which may adversely impact our ability to raise additional capital until August 2011. If we are not able to raise the capital as required, we will be unable to fully implement our expanded business model, and the State of Alaska could terminate the leases which comprise substantially all of our Cook Inlet Basin assets. We may also be required to reduce overhead until further capital is obtained.

During the first quarter of fiscal 2011, Cook Inlet Energy was one of nine successful bidders in State of Alaska's Division of Oil & Gas Cook Inlet Areawide 2010 Competitive Oil and Gas Lease Sale. There were 38 bids for 36 tracts covering an estimated 144,640 acres of State of Alaska oil and gas acreage. Cook Inlet Energy bid on seven tracts and was the successful high bidder on each of those tracts which cover an estimated 27,520 acres. Cook Inlet Energy's winning bid for these seven tracts was \$908,800. Cook Inlet Energy paid a deposit of \$181,767 at the time of the auction and the balance will be due once the title work is complete which we presently anticipate to be in January 2011. All of Cook Inlet Energy's bids completed acreage positions covering prospects acquired in its purchase of a portfolio of Pacific Energy Alaska assets. We have not included this acreage in our calculation of gross or net lease acres in this report.

On May 25, 2010, Cook Inlet Energy entered into a letter agreement with Buccaneer Alaska, LLC to assign four leases with a total gross acreage of 8,828.5 acres to Buccaneer Alaska for a total consideration of \$12,500.00. The effective date of the assignment was June 1, 2010. We retained the following overriding royalty interests in each lease including 2% in the ADL-391108 and ADL-17595-2 leases and 4% in the ADL-390379 and ADL-390370 leases. If Buccaneer Alaska fails to drill at least one well on the leased acreage by 2013, we will be entitled to a payment of \$303,613, and may choose to cause Buccaneer Alaska to assign any of the leases to us that remain active.

LEASES AND LICENSES

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During fiscal 2010 our three acquisitions resulted in additional gross leases and licenses of 642,681 acres and additional net leases and licenses of 596,239 acres bringing the total oil and gas leases and licenses held by us to gross leases and licenses of 657,170 acres and net leases and licenses of 610,728 acres. After the sale and assignment of leases to Buccaneer Alaska, those numbers are 634,219 acres (gross) and 597,224 acres (net). We retained overriding royalty interests ("ORRI") in the acres sold to Buccaneer Alaska, and hold a total 25,964 acres in ORRIs in Alaska. We do not include the ORRI acreage in our calculation of leased and licensed acreage. The terms of these new leases and licenses have a net revenue interest ranging from 0.1% to 100.0% and run from three to five years. We are presently reviewing these leases, as well as our other existing leases, and licenses, to determine the capital requirements and timing for drilling additional wells. To expand our operations by drilling on these leases, we will require additional capital. As a part of our fiscal 2008 sale to Atlas Energy, we retained a 5% royalty interest on a 1,930 acre tract that we expect to be the subject of Atlas Energy drilling. When wells are developed on this acreage, we stand to share in any profit they create. Additionally, we retained the right to participate in up to ten wells with a 25% working interest without promote.

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### RESULTS OF OPERATIONS

#### REVENUES

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The following table shows the components of our revenues for the three months ended July 31, 2010 and 2009, together with their percentages of total revenue in 2010 and percentage change on a period-over-period basis.

|                              | For the Three Months Ended |                 |                  |                 |          |
|------------------------------|----------------------------|-----------------|------------------|-----------------|----------|
|                              | July 31,<br>2010           | % of<br>Revenue | July 31,<br>2009 | % of<br>Revenue | % Change |
|                              |                            |                 |                  |                 |          |
| REVENUES                     |                            |                 |                  |                 |          |
| Oil and gas revenue .....    | \$4,791,179                | 92%             | \$ 404,392       | 77%             | 1,085%   |
| Service and drilling revenue | 409,068                    | 8%              | 123,228          | 23%             | 232%     |
|                              |                            |                 |                  |                 |          |
| Total Revenue .....          | \$5,200,247                | 100%            | \$ 527,620       | 100%            | 886%     |

Oil and gas revenue represents revenues generated from the sale of oil and natural gas produced from the wells in which we have a partial ownership interest. Oil and gas revenue is recognized as income as production is extracted and sold. We reported over 1,000% increase in oil and gas revenues for the three months ended July 31, 2010 over the three months ended July 31, 2009. This increase was due to the addition of the Alaskan oil well production during fiscal 2010 which accounted for revenues of approximately \$4,656,588 during the first quarter of fiscal 2011.

At July 31, 2010 oil was priced at \$78.85 per barrel versus \$69.26 at July 31, 2009 and at July 31, 2010 natural gas was \$4.92 per Mcf as compared to \$3.65 per Mcf at July 31, 2009. In addition, we had 186 producing oil wells and 323 producing gas wells on July 31, 2010 compared to 173 producing oil wells and 253 producing gas wells on July 31, 2009. For the three months ended July 31, 2010 we produced 72,788 barrels of oil and 78,700 Mcf of natural gas as compared to 2,449 barrels of oil and 19,131 Mcf of natural gas during the three months ended July 31, 2009.

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Service and drilling revenue represents revenues generated from drilling, maintenance and repair of third party wells. Service and drilling income is recognized at the time it is both earned and we have a contractual right to receive the revenue. Our service and drilling revenue increased 232% for the three months ended July 31, 2010 as compared to the three months ended July 31, 2009. During the three months ended July 31, 2010 we entered into a contract with National Park Service for plugging non-company related abandoned wells located in the Big South Fork area in Tennessee and Kentucky and recorded \$133,445 of revenue. In addition, for the three months ended July 31, 2010, we record a full quarter's worth of service revenue for our subsidiary, East Tennessee Consultants, Inc. which resulted in revenue of \$157,902 as compared \$65,541 recorded during the three months ended July 31, 2009. East Tennessee Consultants, Inc. was acquired on June 18, 2009.

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### DIRECT EXPENSES

The following tables show the components of our direct expenses for the three months ended July 31, 2010 and 2009. Percentages listed in the table reflect margins for each component of direct expenses and percentages of total revenue for each component of other expenses.

|                             | For the Three Months Ended |        |                  |        |
|-----------------------------|----------------------------|--------|------------------|--------|
|                             | July 31,<br>2010           | Margin | July 31,<br>2009 | Margin |
| DIRECTIONS                  |                            |        |                  |        |
| Oil and gas .....           | \$2,304,107                | 52%    | \$ 24,044        | 94%    |
| Service and drilling .....  | 495,747                    | (21)%  | 244,500          | (98)%  |
| Depletion expense .....     | 1,576,848                  | n/a    | 117,434          | n/a    |
| Total direct expenses ..... | \$4,376,702                | 16%    | \$ 385,978       | 27%    |

We follow the successful efforts method of accounting for our oil and gas activities. Accordingly, costs associated with the acquisition, drilling and equipping of successful exploratory wells are capitalized. During the three months ended July 31, 2010 we capitalized approximately \$3,869,738 of costs associated with the acquisition, drilling and equipping of these wells as compared to \$19,036 during the three months ended July 31, 2009. However, geological and geophysical costs, delay and surface rentals and drilling costs of unsuccessful exploratory wells are charged to expense as incurred and are included in the cost of service and drilling revenue. Finally, costs of drilling development wells are capitalized. Upon the sale or retirement of oil and gas properties, the cost thereof and the accumulated depreciation or depletion are removed from the accounts and any gain or loss is credited or charged to operations. During the three months ended July 31, 2010, oil and gas expenses increased \$2,280,063 from the three months ended July 31, 2009, which was primarily due to the dollars we spent to generate oil and gas revenue at our Alaska operations.

The cost of service and drilling revenue represents direct labor costs of employees associated with these services, as well as costs associated with equipment, parts and repairs. During the three months ended July 31, 2010, service and drilling expenses increased \$251,247 from the three months ended July 31, 2009, which approximately half was due to the costs associated with the contract with National Park Service for plugging abandoned wells.



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Depletion of capitalized costs of proved oil and gas properties is provided on a pooled basis using the units-of-production method based upon proved reserves. Acquisition costs of proved properties are amortized by using total estimated units of proved reserves as the denominator. All other costs are amortized using total estimated units of proved developed reserves. During the three months ended July 31, 2010 depletion expense was \$1,576,848 or 30% of total revenue, as compared to 22% for the three months ended July 31, 2009. The primary reason for the increase in depletion expense for the three months ended July 31, 2010 was the addition of well production due to acquisitions.

As a result of these components, total direct expenses reflected a margin of 16% for the three months ended July 31, 2010. This represented a decreased margin of 11% experienced for the three months ended July 31, 2009. As a result of higher depletion costs, pipeline transportation costs and royalties payable to Alaska, our gross margins on oil and gas sales from our Alaskan operations will generally be less than oil and gas sales from our Appalachian operations. Given that oil and gas sales from our Alaskan operations are expected to represent the majority of our oil and gas sales in future periods, we anticipate that our gross margins will be lower than those which were historically reported before we acquired these assets.

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### OTHER EXPENSES (REVENUES)

The following tables show the components of our other expenses (revenues) for the three months ended July 31, 2010 and 2009. Percentages listed in the table reflect percentages of total revenue for each component of other expenses.

|   | For the Three Months Ended |                 |                  |                 |
|---|----------------------------|-----------------|------------------|-----------------|
|   | July 31,<br>2010           | % of<br>Revenue | July 31,<br>2009 | % of<br>Revenue |
| <b>OTHER EXPENSES (REVENUES)</b>                  |                            |                 |                  |                 |
| Selling, general and administrative               | \$ 2,766,673               | 53%             | \$ 652,392       | 124%            |
| Depreciation and amortization .....               | 413,824                    | 8%              | 111,727          | 21%             |
| Interest expense, net of interest<br>income ..... | 214,785                    | 4%              | 4,898            | 1%              |
| Gain on derivative securities .....               | (2,905,957)                | (56)%           | --               | n/a             |
| Loan fees and costs .....                         | 90,380                     | 2%              | 52,636           | 10%             |
| Gain on sale of property and<br>equipment .....   | 12,500                     | 0%              | 9,755            | 2%              |
| Loss (gain) on acquisitions .....                 | --                         |                 |                  |                 |