

DIRECTORS' REPORT

BOARD INFORMATION

Your Directors present their report on Carbon Energy and its controlled entities for the financial year ended 30 June 2011.

Directors

Directors in office at the date of this report.



C. Rawlings (appointed 1 July 2011) - Chairman



K. Robinson - Non-Executive Director



A.M. Dash - Managing Director



M.D.J. Cozijn - Non-Executive Director



H. M. Garnett (appointed 6 September 2010) - Non-Executive Director



P.N. Hogan - Non-Executive Director



L.I. Rozman - Non-Executive Director

Company Secretary

Mr P Nair was appointed the Company Secretary on 1 January 2009. Details of Mr Nair's experience and qualifications are set out in the information on Directors and Company Secretary in the Directors' Report.



Principal activities

The principal activities of the Consolidated Group during the financial year were:

- to successfully construct and commission its Underground Coal Gasification (UCG) project in Queensland, applying its world leading UCG technology, keyseam; and
- to build a portfolio of coal resource assets.

Operating results

The consolidated loss of the Consolidated Group after providing for income tax amounted to \$15,840,856 (2010: loss \$10,820,487).

Dividends paid or recommended

No dividend was paid or declared during the year and the Directors do not recommend the payment of a dividend.

Review of operations

A review of the Consolidated Group's operations during the year and the results of those operations are contained in pages 10 to 21 of this Annual Report.

Financial position

The net assets of the Consolidated Group have increased by \$21,378,970 to \$175,936,838 during the financial year. The net increase is largely due to the acquisition of Clean Coal Exploration assets and options to coal leases located in Wyoming and Montana (USA) and joint venture rights in Amasra (Turkey) as well as the capital raising announced in December 2010.

The Directors are of the opinion the Group will require to undertake a capital raising to maintain a strong and stable financial position to progress its objectives and strategy.

Impact of proposed carbon tax

The Federal Government introduced the Clean Energy Bill in July 2011 which proposes a fixed carbon price of \$23/tonne from 1 July 2012, moving to a market price three years later. The proposal is intended to replace older technologies with higher emissions to newer and cleaner technologies. As a result Carbon Energy's lower emission use of coal in its UCG process is likely to be a beneficiary of carbon pricing should the legislation be passed through Parliament. Our ability to separate carbon dioxide from syngas prior to combustion means we are likely to have an advantage compared to the higher cost of capturing CO₂ from coal after combustion.

Significant changes in state of affairs

The following significant changes in the state of affairs of the Parent entity occurred during the financial year:

- (i) Dr Helen Garnett was appointed as a Non-Executive Director to the Board on 6 September 2010. Dr Garnett is an accomplished Company Director with over 16 years experience. Additionally, Dr Garnett took the role of Chair for the Company's Audit Committee.
- (ii) On 9 December 2010 Carbon Energy completed a share placement of approximately 61 million shares at \$0.33 to raise \$20 million, before costs. Approximately \$10 million (gross) received from the first tranche of capital raising in December 2010 with the remainder of funds from the second tranche (\$10 million gross) received January 2011.

(iii) Mr Ian Walker resigned on 31 December 2010 as a Non-Executive Director to assist the Company in restructuring the Board as Carbon Energy evolves as an international energy company. The Board and Management wish to record our sincere appreciation for the significant contribution Ian has made in the advancement of Carbon Energy, and we wish Ian every success in his future endeavours.

(iv) On 6 April 2011 Carbon Energy acquired exploration assets and options to coal leases located in Wyoming and Montana (USA) and joint venture rights in Amasra (Turkey) for a total consideration of \$US 19 million (including deferred consideration of US \$9 million) Consideration of 27,645,208 Carbon Energy shares has been issued (US\$10 million of shares based on 60 day Volume Weighted Average Price (VWAP) preceding the date of execution of the agreement of 23 February 2011). Two further tranches of US\$4.5 million of shares each (based on 30 day VWAP at time of milestone achievement) will be issued subject to meeting key development milestones including the delineation of JORC compliant coal resources in excess of 500Mt at two of the three locations.

(v) Dr Cliff Mallett stepped down from the Board on 30 June 2011 but has remained as an Executive of Carbon Energy.

After balance date events

On 1st July 2011, Dr Christopher Rawlings joined the Board as a Non-Executive Director (and Chairman) of Carbon Energy Limited and was appointed Chairman from 26 July 2011.

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On 12th July 2011 Department of Environment and Resource Management advised the Company of charges in relation to spillage of process water in 2009. Proceedings have been adjourned to 20 September 2011.

No other matters of substance have arisen since the end of the financial year, which significantly affected or may significantly affect the operations of the Consolidated Group, the results of those operations and the state of affairs of the Consolidated Group in subsequent financial years.

Future developments

Future developments in the operations of the Consolidated Group are referred to in the Chairman's Report on page 8 – 9 of this Annual Report. Further information regarding likely developments in the operations of the Consolidated Group and likely results of those operations would, in the opinion of the Directors, be speculative and not in the best interests of the Consolidated Group.

Environmental issues

The Consolidated Group's operations are subject to significant environmental regulation under the Laws of the Commonwealth and State. On 20 August 2010, Carbon Energy submitted an Environmental Evaluation of its Bloodwood Creek site as requested by Queensland Department of Environment and Resource Management (DERM). The evaluation relates to an incident that occurred during 2009 at the Bloodwood Creek site which involved the release of UCG process water onto the ground with an amount running into a pond at Bloodwood Creek. An immediate spill response was initiated with the water being pumped out and

affected soils removed. Water sampling results have concluded that no ongoing environmental harm has occurred as a result. In November 2010 DERM accepted Carbon Energy's environmental report as addressing the requirements of the Environmental Evaluation notice issued on 21 July 2010 and additional information notice issued on 21 September 2010. Subsequently in February 2011, DERM approved the initiation of UCG Panel 2 enabling Carbon Energy to continue its Queensland operations at Bloodwood Creek. On 12 July 2011 DERM advised Carbon Energy of charges laid against the Company. Proceedings have been adjourned to 20 September 2011.

Mineral exploration

In Queensland, the Company has lodged financial assurance bonds for Environmental Authority Permits and associated security bonds of \$55,640.

Coal exploration and UCG

Carbon Energy prides itself on the Company's environmental track record which, apart from the one isolated and rectified incident mentioned above, has remained untarnished. The Carbon Energy UCG project at Bloodwood Creek has complied with the conditions of the Environmental Authority Number MIN200647007 which was issued by the Environmental Protection Authority on December 2007. The Environmental Authority regulates the environmental aspects of all UCG activities authorised to be conducted on Mineral Development Licence 374. In addition, on 13 April 2010 Petroleum Facility Licence No. 6 was granted to Carbon Energy together with Environmental Authority PEN200236408. This is for the processing of syngas on the Mining Development Lease area

which requires a separate tenure and approval under the Petroleum and Gas Act (Production and Safety) 2004. Both Environmental Authorities were amended on the 11th of February 2011.

Carbon Energy has obtained all regulatory approvals, including environmental approvals, to enable the UCG pilot project and associated activities to be conducted on MDL 374, based on the submission and approval of the Environmental Management Plan. The growth and activities on-site requires an update of the Environmental Management Plan. The increasing scale of activities on site requires the existing Level 2 Environmental Authorities to be upgraded to Level 1 Environmental Authorities. Applications for these amendments have been lodged with the Department of Environment and Resource Management and are being assessed. The government agencies involved in permitting the pilot project have included the Department of Employment, Economic Development and Innovation, the Department of Environment and Resource Management, and the Department of Infrastructure and Planning.