CABOT OIL & GAS CORP
Form 10-Q
October 26, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2012

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

Commission file number 1-10447

CABOT OIL & GAS CORPORATION

(Exact name of registrant as specified in its charter)

DELAWARE	**04-3072771**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

Three Memorial City Plaza

840 Gessner Road, Suite 1400, Houston, Texas 77024

(Address of principal executive offices including ZIP code)

(281) 589-4600

(Registrant s telephone number, including area code)

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 and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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 reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

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

As of October 22, 2012, there were 210,242,354 shares of Common Stock, Par Value $.10 Per Share, outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

CABOT OIL & GAS CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEET (Unaudited)

(In thousands, except share amounts)	September 30, 2012	December 31, 2011
ASSETS		
Current Assets		
Cash and Cash Equivalents	**$ 37,501**	$ 29,911
Accounts Receivable, Net	**103,634**	114,381
Income Taxes Receivable	**1,183**	1,388
Inventories	**17,696**	21,278
Derivative Instruments	**61,723**	174,263
Other Current Assets	**2,937**	4,579
Total Current Assets	**224,674**	345,800
Properties and Equipment, Net (Successful Efforts Method)	**4,218,921**	3,934,584
Derivative Instruments	**4,379**	21,249
Other Assets	**34,963**	29,860
	$ 4,482,937	$ 4,331,493
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts Payable	**$ 276,149**	$ 217,294
Current Portion of Long-Term Debt	**75,000**	
Deferred Income Taxes	**14,229**	55,132
Accrued Liabilities	**47,412**	70,918
Total Current Liabilities	**412,790**	343,344
Postretirement Benefits	**40,993**	38,708
Long-Term Debt	**987,000**	950,000
Deferred Income Taxes	**837,319**	802,592
Asset Retirement Obligation	**63,069**	60,142
Other Liabilities	**41,479**	31,939
Total Liabilities	**2,382,650**	2,226,725
Commitments and Contingencies		
Stockholders Equity		
Common Stock:		
Authorized 480,000,000 Shares of $0.10 Par Value in 2012 and 240,000,000 Shares of $0.10 Par Value in 2011 Issued 210,242,354 Shares and 209,019,458 Shares in 2012 and 2011, respectively	**21,024**	20,902
Additional Paid-in Capital	**718,760**	724,377

Retained Earnings		**1,336,594**		1,258,291
Accumulated Other Comprehensive Income		**27,258**		104,547
Less Treasury Stock, at Cost:				
404,400 Shares in 2012 and 2011, respectively		**(3,349)**		(3,349)
Total Stockholders Equity		**2,100,287**		2,104,768
	$	**4,482,937**	$	4,331,493

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

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CABOT OIL & GAS CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS (Unaudited)

(In thousands, except per share amounts)	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
OPERATING REVENUES				
Natural Gas	**$ 231,896**	$ 218,521	**$ 639,729**	$ 588,976
Crude Oil and Condensate	**57,870**	33,158	**165,317**	79,792
Brokered Natural Gas	**5,238**	9,467	**23,831**	38,947
Other	**1,870**	971	**5,790**	4,124
	296,874	262,117	**834,667**	711,839
OPERATING EXPENSES				
Direct Operations	**28,269**	27,292	**84,895**	76,878
Transportation and Gathering	**34,430**	19,768	**97,827**	48,710
Brokered Natural Gas	**4,258**	8,204	**20,380**	33,362
Taxes Other Than Income	**10,436**	7,042	**39,873**	21,070
Exploration	**9,303**	20,190	**29,548**	31,090
Depreciation, Depletion and Amortization	**110,448**	90,293	**335,421**	250,642
General and Administrative	**23,829**	27,949	**93,249**	78,254
	220,973	200,738	**701,193**	540,006
Gain / (Loss) on Sale of Assets	**(126)**	3,854	**67,042**	36,408
INCOME FROM OPERATIONS	**75,775**	65,233	**200,516**	208,241
Interest Expense and Other	**16,219**	18,517	**51,631**	53,928
Income Before Income Taxes	**59,556**	46,716	**148,885**	154,313
Income Tax Expense	**22,948**	18,234	**58,021**	58,268
NET INCOME	**$ 36,608**	$ 28,482	**$ 90,864**	$ 96,045
Earnings Per Share				
Basic	**$ 0.17**	$ 0.14	**$ 0.43**	$ 0.46
Diluted	**$ 0.17**	$ 0.14	**$ 0.43**	$ 0.46
Weighted-Average Shares Outstanding				
Basic	**209,656**	208,570	**209,433**	208,463
Diluted	**211,226**	210,920	**210,997**	210,631
Dividends per common share	**$ 0.02**	$ 0.02	**$ 0.06**	$ 0.05

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

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CABOT OIL & GAS CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (Unaudited)

(In thousands)	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Net Income	**$ 36,608**	$ 28,482	**$ 90,864**	$ 96,045
Other Comprehensive Income / (Loss), net of taxes:				
Reclassification Adjustment for Settled Hedge Contracts*(1)*	**(37,294)**	(13,982)	**(115,943)**	(30,308)
Changes in Fair Value of Hedge Contracts*(2)*	**(24,361)**	60,829	**30,091**	98,607
Defined Benefit Pension and Postretirement Plans:				
Net Loss due to Remeasurement*(3)*		(2,487)		(2,487)
Settlement*(4)*		1,516		1,516
Amortization of Net Obligation at Transition*(5)*		98		294
Amortization of Prior Service Cost*(6)*		141	**135**	534
Amortization of Net Loss*(7)*	**79**	1,559	**8,428**	5,530
Foreign Currency Translation Adjustment*(8)*		31		23
Total Other Comprehensive Income / (Loss)	**(61,576)**	47,705	**(77,289)**	73,709
Comprehensive Income / (Loss)	**$ (24,968)**	$ 76,187	**$ 13,575**	$ 169,754

(1) Net of income taxes of $23,644 and $8,570 for the three months ended September 30, 2012 and 2011, respectively, and $73,507 and $18,576 for the nine months ended September 30, 2012 and 2011, respectively.

(2) Net of income taxes of $15,444 and $(37,314) for the three months ended September 30, 2012 and 2011, respectively, and $(19,208) and $(60,423) for the nine months ended September 30, 2012 and 2011, respectively.

(3) Net of income taxes of $0 and $1,614 for the three months ended September 30, 2012 and 2011, respectively, and $0 and $1,614 for the nine months ended September 30, 2012 and 2011, respectively.

(4) Net of income taxes of $0 and $(930) for the three months ended September 30, 2012 and 2011, respectively, and $0 and $(930) for the nine months ended September 30, 2012 and 2011, respectively.

(5) Net of income taxes of $0 and $(60) for the three months ended September 30, 2012 and 2011, respectively, and $0 and $(180) for the nine months ended September 30, 2012 and 2011, respectively.

(6) Net of income taxes of $0 and $(87) for the three months ended September 30, 2012 and 2011, respectively and $(86) and $(328) for the nine months ended September 30, 2012 and 2011, respectively.

(7) Net of income taxes of $(53) and $(954) for the three months ended September 30, 2012 and 2011, respectively and $(5,347) and $(3,390) for the nine months ended September 30, 2012 and 2011, respectively.

(8) Net of income taxes of $0 and $(6) for the three months ended September 30, 2012 and 2011, respectively and $0 and $(9) for the nine months ended September 30, 2012 and 2011, respectively.

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

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CABOT OIL & GAS CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS (Unaudited)

(In thousands)	Nine Months Ended September 30, 2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Income	**$ 90,864**	$ 96,045
Adjustments to Reconcile Net Income to Cash Provided by Operating Activities:		
Depreciation, Depletion and Amortization	**335,421**	250,642
Deferred Income Tax Expense	**42,714**	57,381
(Gain) / Loss on Sale of Assets	**(67,042)**	(36,408)
Exploration Expense	**12,118**	13,851
Unrealized (Gain) / Loss on Derivative Instruments	**449**	950
Amortization of Debt Issuance Costs	**4,300**	3,317
Stock-Based Compensation, Pension and Other	**37,518**	42,432
Changes in Assets and Liabilities:		
Accounts Receivable, Net	**10,747**	(7,124)
Income Taxes	**205**	(36,115)
Inventories	**3,582**	1,371
Other Current Assets	**(1,125)**	(832)
Accounts Payable and Accrued Liabilities	**(16,391)**	(9,941)
Other Assets and Liabilities	**1,752**	(203)
Net Cash Provided by Operating Activities	**455,112**	375,366
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital Expenditures	**(669,198)**	(668,987)
Proceeds from Sale of Assets	**132,740**	82,109
Investment in Equity Method Investment	**(4,488)**	
Net Cash Used in Investing Activities	**(540,946)**	**(586,878)**
CASH FLOWS FROM FINANCING ACTIVITIES		
Borrowings from Debt	**280,000**	330,000
Repayments of Debt	**(168,000)**	(100,000)
Dividends Paid	**(12,561)**	(9,379)
Capitalized Debt Issuance Costs	**(5,005)**	(1,025)
Other	**(1,010)**	(1,105)
Net Cash Provided by Financing Activities	**93,424**	218,491
Net Increase / (Decrease) in Cash and Cash Equivalents	**7,590**	6,979
Cash and Cash Equivalents, Beginning of Period	**29,911**	55,949
Cash and Cash Equivalents, End of Period	**$ 37,501**	$ 62,928

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

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CABOT OIL & GAS CORPORATION

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. FINANCIAL STATEMENT PRESENTATION

During interim periods, Cabot Oil & Gas Corporation (the Company) follows the same accounting policies disclosed in its Annual Report on Form 10-K for the year ended December 31, 2011 (Form 10-K) filed with the Securities and Exchange Commission (SEC). The interim financial statements should be read in conjunction with the notes to the consolidated financial statements and information presented in the Form 10-K. In management s opinion, the accompanying interim condensed consolidated financial statements contain all material adjustments, consisting only of normal recurring adjustments, necessary for a fair statement. The results for any interim period are not necessarily indicative of the expected results for the entire year.

Certain reclassifications have been made to prior year statements to conform with current year presentation. These reclassifications have no impact on previously reported net income.

On January 3, 2012, the Board of Directors declared a 2-for-1 split of the Company s common stock in the form of a stock dividend. The stock dividend was distributed on January 25, 2012 to shareholders of record as of January 17, 2012. All common stock accounts and per share data have been retroactively adjusted to give effect to the 2-for-1 split of the Company s common stock.

With respect to the unaudited financial information of the Company as of September 30, 2012 and for the three and nine months ended September 30, 2012 and 2011, PricewaterhouseCoopers LLP reported that they have applied limited procedures in accordance with professional standards for a review of such information. However, their separate report dated October 26, 2012 appearing herein states that they did not audit and they do not express an opinion on that unaudited financial information. Accordingly, the degree of reliance on their report on such information should be restricted in light of the limited nature of the review procedures applied. PricewaterhouseCoopers LLP is not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their report on the unaudited financial information because that report is not a report or a part of the registration statement prepared or certified by PricewaterhouseCoopers LLP within the meaning of Sections 7 and 11 of the Act.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The amendments in this update generally represent clarifications of Topic 820, but also include some instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. This update results in common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and IFRS. The amendments are effective for interim and annual periods beginning after December 15, 2011 and are to be applied prospectively. This update did not have any

impact on the Company s consolidated financial position, results of operations or cash flows.

In June 2011, the FASB issued ASU No. 2011-05, Presentation of Comprehensive Income. ASU No. 2011-05 was amended in December 2011 by ASU No. 2011-12, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU No. 2011-05. ASU No. 2011-12 defers only those changes in ASU No. 2011-05 that relate to the presentation of reclassification adjustments. All other requirements in ASU No. 2011-05 are not affected by ASU No. 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. ASU No. 2011-05 and 2011-12 are effective for fiscal years (including interim periods) beginning after December 15, 2011. The Company has elected to present two separate but consecutive financial statements. These updates did not have any impact on the Company s consolidated financial position, results of operations or cash flows.

In December 2011, the FASB issued ASU No. 2011-11, Disclosures about Offsetting Assets and Liabilities. The amendments in this update require enhanced disclosures around financial instruments and derivative instruments that are either (1) offset in accordance with either Accounting Standards Codification (ASC) 210-20-45 or ASC 815-10-45 or (2) subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with either ASC 210-20-45 or ASC 815-10-45. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The amendments are effective during interim and annual periods beginning on or after January 1, 2013. This guidance will primarily impact the Company s disclosures associated with its commodity derivatives. The Company does not expect this guidance to have any impact on its consolidated financial position, results of operations or cash flows.

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2. PROPERTIES AND EQUIPMENT, NET

Properties and equipment, net are comprised of the following:

(In thousands)	September 30, 2012	December 31, 2011
Proved Oil and Gas Properties	**$ 5,618,507**	$ 5,006,846
Unproved Oil and Gas Properties	**478,999**	478,942
Gathering and Pipeline Systems	**238,962**	238,660
Land, Building and Other Equipment	**83,301**	80,908
	6,419,769	5,805,356
Accumulated Depreciation, Depletion and Amortization	**(2,200,848)**	(1,870,772)
	$ 4,218,921	$ 3,934,584

At September 30, 2012, the Company did not have any projects that had exploratory well costs that were capitalized for a period of greater than one year after drilling.

Divestitures

In June 2012, the Company sold a 35% non-operated working interest associated with certain of its Pearsall shale undeveloped leaseholds in south Texas to a wholly-owned subsidiary of Osaka Gas Co., Ltd. (Osaka) for total consideration of approximately $251.0 million. The Company received $125.0 million in cash proceeds and Osaka agreed to fund 85% of the Company s share of future drilling and completion costs associated with these leaseholds until it has paid approximately $126.0 million in accordance with a joint development agreement entered into at the closing. The drilling and completion carry will terminate two years after the closing of the transaction. The Company recognized a $67.0 million gain on sale of assets associated with this sale.

During the first nine months of 2011, the Company entered into two participation agreements with third parties related to certain of its Haynesville and Bossier shale leaseholds in east Texas. Under the terms of the participation agreements, the third parties agreed to fund 100% of the cost to drill and complete certain Haynesville and Bossier shale wells in the related leaseholds over a multi-year period in exchange for a 75% working interest in the leaseholds. During the first nine months of 2011, the Company received reimbursement of drilling costs incurred of approximately $11.2 million associated with wells that had commenced drilling prior to the execution of the participation agreements.

In May 2011, the Company sold certain of its Haynesville and Bossier Shale oil and gas properties in east Texas to a third party. The Company received approximately $47.0 million in cash proceeds and recognized a $34.2 million gain on sale of assets.

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3. ADDITIONAL BALANCE SHEET INFORMATION

Certain balance sheet amounts are comprised of the following:

(In thousands)	September 30, 2012	December 31, 2011
ACCOUNTS RECEIVABLE, NET		
Trade Accounts	**$ 99,753**	$ 111,306
Joint Interest Accounts	**3,804**	5,417
Other Accounts	**1,092**	1,003
	104,649	117,726
Allowance for Doubtful Accounts	**(1,015)**	(3,345)
	$ 103,634	$ 114,381
INVENTORIES		
Natural Gas in Storage	**$ 10,122**	$ 13,513
Tubular Goods and Well Equipment	**6,507**	7,146
Other Accounts	**1,067**	619
	$ 17,696	$ 21,278
OTHER CURRENT ASSETS		
Prepaid Balances and Other	**2,937**	2,345
Restricted Cash		2,234
	$ 2,937	$ 4,579
OTHER ASSETS		
Deferred Compensation Plan	**$ 11,462**	$ 10,838
Debt Issuance Cost	**18,385**	17,680
Equity Method Investment	**4,450**	
Other Accounts	**666**	1,342
	$ 34,963	$ 29,860
ACCOUNTS PAYABLE		
Trade Accounts	**$ 17,511**	$ 18,253
Natural Gas Purchases	**4,277**	3,012
Royalty and Other Owners	**47,699**	48,113
Accrued Capital Costs	**164,139**	138,122
Taxes Other Than Income	**1,415**	2,076
Drilling Advances	**33,244**	1,489
Wellhead Gas Imbalances	**2,358**	2,312
Other Accounts	**5,506**	3,917
	$ 276,149	$ 217,294
ACCRUED LIABILITIES		
Employee Benefits	**$ 16,360**	$ 26,035
Pension and Postretirement Benefits	**1,260**	6,331
Taxes Other Than Income	**12,450**	12,297
Interest Payable	**12,801**	24,701
Derivative Contracts	**2,941**	385
Other Accounts	**1,600**	1,169
	$ 47,412	$ 70,918
OTHER LIABILITIES		
Deferred Compensation Plan	**$ 22,668**	$ 20,187
Derivative Contracts	**5,868**	
Other Accounts	**12,943**	11,752
	$ 41,479	$ 31,939

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4. DEBT AND CREDIT AGREEMENTS

The Company s debt and credit agreements consisted of the following:

(In thousands)	September 30, 2012	December 31, 2011
Long-Term Debt		
7.33% Weighted-Average Fixed Rate Notes	**$ 95,000**	$ 95,000
6.51% Weighted-Average Fixed Rate Notes	**425,000**	425,000
9.78% Notes	**67,000**	67,000
5.58% Weighted-Average Fixed Rate Notes	**175,000**	175,000
Credit Facility	**300,000**	188,000
Current Maturities		
7.33% Weighted-Average Fixed Rate Notes	**(75,000)**	
Long-Term Debt, excluding Current Maturities	**$ 987,000**	**$ 950,000**

In May 2012, the Company amended its revolving credit facility to adjust the margins associated with borrowings under the facility and extend the maturity date from September 2015 to May 2017. The credit facility, as amended, provides for an available credit line of $900 million with an accordion feature, which allows the Company to increase the available credit line by an additional $500 million if one or more of the existing or new banks agree to provide such increased amount. Interest rates under the credit facility are based on Euro-Dollars (LIBOR) or Base Rate (Prime) indications, plus a margin, as follows:

	Debt Percentage				
	<25%	**≥25% <50%**	**≥50% <75%**	**≥75% <90%**	**≥90%**
Eurodollar Loans	1.50%	1.75%	2.00%	2.25%	2.50%
ABR Loans	0.50%	0.75%	1.00%	1.25%	1.50%

As of September 30, 2012, the amended credit facility provided for a $1.7 billion borrowing base. The other terms and conditions of the amended facility are generally consistent with the terms and conditions of the credit agreement prior to its amendment.

In conjunction with entering into the amendment to the credit facility, the Company incurred $5.0 million of debt issuance costs, which were capitalized and will be amortized over the term of the amended credit facility. Approximately $1.3 million in unamortized cost associated with the original credit facility was recognized as a debt extinguishment cost, which was included in Interest Expense and Other in the Condensed Consolidated Statement of Operations, and the remaining unamortized costs of $11.0 million will be amortized over the term of the amended credit facility in accordance with ASC 470-50, Debt Modifications and Extinguishments.

At September 30, 2012, the Company had $300.0 million of borrowings outstanding under the amended credit facility at a weighted-average interest rate of 2.3% and $599.0 million available for future borrowings.

5. EQUITY METHOD INVESTMENT

Constitution Pipeline Company, LLC

The Company accounts for its investment in entities over which the Company has significant influence, but not control, using the equity method of accounting. Under the equity method of accounting, the Company records its proportionate share of net earnings, declared dividends and partnership distributions based on the most recently available financial statements of the investee (generally on a one month lag). The Company also evaluates its equity method investments for potential impairment whenever events or changes in circumstances indicate that there is an other-than-temporary decline in the value of the investment.

In February 2012, the Company entered into a Precedent Agreement with Constitution Pipeline Company, LLC (Constitution), at the time a wholly owned subsidiary of Williams Partners L.P., to develop and construct a 120 mile large diameter pipeline to transport its production in northeast Pennsylvania to both the New England and New York markets. Under the terms of the Precedent Agreement, the Company will have transportation rights for up to approximately 500,000 Mcf per day of capacity on the newly constructed pipeline, subject to regulatory approval and certain terms and conditions to be determined.

In April 2012, the Company entered into an Amended and Restated Limited Liability Company Agreement (LLC Agreement) with Constitution, which thereby became an unconsolidated investee. Under the terms of the LLC Agreement, the Company acquired a

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25% equity interest and agreed to invest approximately $187 million, subject to a contribution cap of $250 million. The investment, which is expected to occur over the next three years, will fund the development and construction of the pipeline and related facilities.

During the first nine months of 2012, the Company made contributions of $4.5 million to fund costs associated with the project. The Company s net book value in this equity investment was $4.5 million as of September 30, 2012 and is included in Other Assets in the Condensed Consolidated Balance Sheet. There were no material earnings or losses associated with Constitution during the first nine months of 2012. Earnings (losses) on Equity Method Investment are included in Interest Expense and Other in the Condensed Consolidated Statement of Operations.

6. EARNINGS PER COMMON SHARE

Basic EPS is computed by dividing net income (the numerator) by the weighted-average number of common shares outstanding for the period (the denominator). Diluted EPS is similarly calculated except that the denominator is increased using the treasury stock method to reflect the potential dilution that could occur if outstanding stock appreciation rights were exercised and stock awards were vested at the end of the applicable period.

The following is a calculation of basic and diluted weighted-average shares outstanding:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
(In thousands)	**2012**	**2011**	**2012**	**2011**
Weighted-Average Shares - Basic	**209,656**	208,570	**209,433**	208,463
Dilution Effect of Stock Appreciation Rights and Stock Awards at End of Period	**1,570**	2,350	**1,564**	2,168
Weighted-Average Shares - Diluted	**211,226**	210,920	**210,997**	210,631
Weighted-Average Stock Awards and Shares Excluded from Diluted Earnings per Share due to the Anti-Dilutive Effect	**46**		**102**	

7. COMMITMENTS AND CONTINGENCIES

Transportation Agreements

During the first nine months of 2012, the Company entered into a liquids transportation agreement that commenced in the third quarter of 2012. The Company s total future minimum transportation commitments as of September 30, 2012 are as follows:

(In thousands)		
2012	$	28,117
2013		121,920
2014		127,620
2015		127,698
2016		128,071
Thereafter		1,289,626
	$	**1,823,052**

For further information on the Company s transportation agreements, please refer to Note 7 of the Notes to the Consolidated Financial Statements in the 2011 Form 10-K.

Legal Matters

Preferential Purchase Right Litigation

In September 2005, the Company and Linn Energy, LLC were sued by Power Gas Marketing & Transmission, Inc. in the Court of Common Pleas of Indiana County, Pennsylvania. The lawsuit seeks unspecified damages arising out of the Company s 2003 sale of oil and gas properties located in Indiana County, Pennsylvania, to Linn Energy, LLC. The plaintiff alleges breach of a preferential purchase right regarding those properties contained in a 1969 joint operating agreement to which the plaintiff was a party. The Company initially obtained judgment as a matter of law as to all claims in a decision by the trial court dated February 2007. Plaintiff

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appealed the ruling to the Pennsylvania Superior Court, where the ruling in favor of the Company was reversed and remanded to the trial court in March 2008. The Company appealed the Superior Court ruling to the Pennsylvania Supreme Court, but in December 2008 that Court declined to review. Effective July 2008, Linn Energy, LLC sold the subject properties to XTO Energy, Inc., giving rise to a second lawsuit for unspecified damages filed in September 2009 by EXCO North Coast Energy, Inc., as successor in interest to Power Gas Marketing & Transmission, Inc., against the Company, Linn Energy, LLC and XTO Energy, Inc. The second lawsuit has been consolidated into the first lawsuit. A bench trial was held in early June 2012. Closing arguments have been set for mid-January 2013.

The Company believes that the plaintiff s claims lack merit and does not consider a loss related to this matter to be probable; however, due to the inherent uncertainties of litigation, a loss is possible. In the event that the Company is found liable, the potential loss is currently estimated to be less than $15 million.

Other

The Company is also a defendant in various other legal proceedings arising in the normal course of business. All known liabilities are accrued based on management s best estimate of the potential loss. While the outcome and impact of these legal proceedings on the Company cannot be predicted with certainty, management believes that the resolution of these proceedings will not have a material effect on the Company s financial position, results of operations or cash flows.

Contingency Reserves

When deemed necessary, the Company establishes reserves for certain legal proceedings. The establishment of a reserve is based on an estimation process that includes the advice of legal counsel and subjective judgment of management. While management believes these reserves to be adequate, it is reasonably possible that the Company could incur additional losses with respect to those matters in which reserves have been established. The Company believes that any such amount above the amounts accrued is not material to the Condensed Consolidated Financial Statements. Future changes in facts and circumstances not currently foreseeable could result in the actual liability exceeding the estimated ranges of loss and amounts accrued.

Environmental Matters

Pennsylvania Department of Environmental Protection

On December 15, 2010, the Company entered into a consent order and settlement agreement (CO&SA) with the Pennsylvania Department of Environmental Protection (PaDEP), addressing a number of environmental issues originally identified in 2008 and 2009, including alleged releases of drilling mud and other substances, alleged record keeping violations at various wells and alleged natural gas contamination of water supplies to 14 households in Susquehanna County, Pennsylvania. On January 11, 2011, certain of the affected households appealed the CO&SA to the Pennsylvania Environmental Hearing Board (PEHB). On October 17, 2011, the Company requested PaDEP approval to resume hydraulic fracturing and new natural gas well drilling operations in the affected area, along with a request to cease temporary water deliveries to the

affected households. On October 18, 2011, the PaDEP concurred that temporary water deliveries to the property owners are no longer necessary. On November 18, 2011, certain of the affected households appealed this order to the PEHB, which appeal was later consolidated with the CO&SA appeal.

The Company is in continuing discussions with the PaDEP to address the results of the Company s natural gas well test data, water quality sampling and water well headspace screenings, which were required pursuant to the CO&SA. On August 21, 2012, the PaDEP notified the Company that it could commence completion operations on existing wells within the concerned area.

As of September 30, 2012, the Company has paid $1.3 million in settlement of fines and penalties sought or claimed by the PaDEP related to this matter and all of the affected households have accepted the $4.2 million that was placed into escrow for their benefit. Furthermore, as of October 18, 2012, all of the appellants have dismissed their appeal to the PEHB. With the withdrawal of these appeals, the Company does not believe it has any further exposure related to this matter.

For additional information on the PaDEP matter, refer to Note 7 of the Notes to the Consolidated Financial Statements in the 2011 Form 10-K.

United States Environmental Protection Agency

By letter dated January 6, 2012, the United States Environmental Protection Agency (EPA) sent a Required Submission of Information Dimock Township Drinking Water Contamination letter to the Company pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, as amended (CERCLA). The Required Submission of Information requested all

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documents, water sampling results and any other correspondence related to the Company s activities in the area of concern. The Company provided information pursuant to the request.

Upon review of information from Dimock residents, the PaDEP, and the Company, the EPA determined that further water well sampling was necessary and initiated two rounds of water sampling to address concerns about drinking water in Dimock. In July 2012, based on the outcome of the water sampling, the EPA determined that levels of contaminants do not pose a health concern and that it would take no further action.

8. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The Company periodically enters into commodity derivative instruments to hedge its exposure to price fluctuations on natural gas and crude oil production. The Company s credit agreement restricts the ability of the Company to enter into commodity hedges other than to hedge or mitigate risks to which the Company has actual or projected exposure or as permitted under the Company s risk management policies and not subjecting the Company to material speculative risks. All of the Company s derivatives are used for risk management purposes and are not held for trading purposes.

As of September 30, 2012, the Company had the following outstanding commodity derivatives:

Commodity and Derivative Type	Weighted-Average Contract Price		Volume		Contract Period
Derivatives Designated as Hedging Instruments					
Natural Gas Swaps	$5.22	per Mcf	24,131	Mmcf	Oct. 2012 - Dec. 2012
Natural Gas Collars	$3.60 Floor / $4.17 Ceiling	per Mcf	2,963	Mmcf	Nov. 2012 - Dec. 2012
Natural Gas Collars	$5.15 Floor / $6.18 Ceiling	per Mcf	10,637	Mmcf	Jan. 2013 - Dec. 2013
Natural Gas Collars	$5.15 Floor / $6.23 Ceiling	per Mcf	7,092	Mmcf	Jan. 2013 - Dec. 2013
Natural Gas Collars	$3.09 Floor / $4.12 Ceiling	per Mcf	35,458	Mmcf	Jan. 2013 - Dec. 2013
Natural Gas Collars	$3.40 Floor / $4.12 Ceiling	per Mcf	17,729	Mmcf	Jan. 2013 - Dec. 2013
Natural Gas Collars	$3.35 Floor / $4.01 Ceiling	per Mcf	35,458	Mmcf	Jan. 2013 - Dec. 2013
Natural Gas Collars	$3.60 Floor / $4.17 Ceiling	per Mcf	17,729	Mmcf	Jan. 2013 - Dec. 2013
Crude Oil Swaps	$100.45	per Bbl	460	Mbbl	Oct. 2012 - Dec. 2012
Crude Oil Swaps	$101.90	per Bbl	1,095	Mbbl	Jan. 2013 - Dec. 2013
Derivatives Not Designated as Hedging Instruments					
Natural Gas Basis Swaps	$(0.25)	per Mcf	4,284	Mmcf	Oct. 2012 - Dec. 2012

In October 2012, the Company entered into additional natural gas collar arrangements with floor prices ranging from $3.76 to $3.86 per Mcf and ceiling prices ranging from $4.14 to $4.36 per Mcf covering 35,458 Mmcf of the Company s anticipated natural gas production for 2013.

The change in fair value of derivatives designated as hedges that is effective is recorded to Accumulated Other Comprehensive Income / (Loss) in Stockholders Equity in the Condensed Consolidated Balance Sheet. The ineffective portion of the change in fair value of derivatives designated as hedges, if any, and the change in fair value of derivatives not designated as hedges are recorded currently in earnings as a component of Natural Gas Revenue and Crude Oil and Condensate Revenue, as appropriate, in the Condensed Consolidated Statement of Operations.

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The following disclosures reflect the impact of derivative instruments on the Company s condensed consolidated financial statements:

Effect of Derivative Instruments on the Condensed Consolidated Balance Sheet

(In thousands)	Balance Sheet Location	Fair Value Asset (Liability) September 30, 2012	December 31, 2011
Derivatives Designated as Hedging Instruments			
Commodity Contracts	Derivative Instruments (current assets)	**$ 62,532**	$ 177,389
Commodity Contracts	Accrued Liabilities	**(2,941)**	(385)
Commodity Contracts	Derivative Instruments (non-current assets)	**4,379**	21,249
Commodity Contracts	Other Liabilities	**(5,868)**	
		58,102	**198,253**
Derivatives Not Designated as Hedging Instruments			
Commodity Contracts	Derivative Instruments (current assets)	**(809)**	(3,126)
		$ 57,293	$ 195,127

At September 30, 2012 and December 31, 2011, unrealized gains of $58.1 million ($35.6 million, net of tax) and $198.3 million ($121.4 million, net of tax), respectively, were recorded in Accumulated Other Comprehensive Income / (Loss). Based upon estimates at September 30, 2012, the Company expects to reclassify $36.5 million in after-tax income associated with its commodity hedges from Accumulated Other Comprehensive Income / (Loss) to the Condensed Consolidated Statement of Operations over the next 12 months.

Effect of Derivative Instruments on the Condensed Consolidated Statement of Operations

Derivatives Designated as Hedging Instruments (In thousands)	Amount of Gain / (Loss) Recognized in OCI on Derivative (Effective Portion) Three Months Ended September 30, 2012	2011	Nine Months Ended September 30, 2012	2011	Location of Gain (Loss) Reclassified from Accumulated OCI into Income	Amount of Gain / (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) Three Months Ended September 30, 2012	2011	Nine Months Ended September 30, 2012	2011
Commodity Contracts	**$ (39,805)**	$ 98,143	**$ 49,299**	$ 159,030	Natural Gas Revenues	**$ 57,139**	$ 21,170	**$ 183,867**	$ 48,318
					Crude Oil and Condensate Revenues	**3,799**	1,382	**5,583**	566
						$ 60,938	$ 22,552	**$ 189,450**	$ 48,884

For the three and nine months ended September 30, 2012 and 2011, respectively, there was no ineffectiveness recorded in our Condensed Consolidated Statement of Operations related to our derivative instruments.

Derivatives Not Designated as Hedging Instruments (In thousands)	Location of Gain (Loss) Recognized in Income on Derivative	Three Months Ended September 30, 2012	2011	Nine Months Ended September 30, 2012	2011
Commodity Contracts	Natural Gas Revenues	**$ (149)**	$ (64)	**$ (449)**	$ (950)

Additional Disclosures about Derivative Instruments and Hedging Activities

The use of derivative instruments involves the risk that the counterparties will be unable to meet their obligation under the agreement. The Company enters into derivative contracts with multiple counterparties in order to limit its exposure to individual counterparties. The Company also has netting arrangements with all of its counterparties that allow it to offset payables against receivables from separate derivative contracts with that counterparty.

Certain counterparties to the Company s derivative instruments are also lenders under its credit facility. The Company s credit facility and derivative instruments contain certain cross default and acceleration provisions that may require immediate payment of its derivative liability in certain situations.

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9. FAIR VALUE MEASUREMENTS

ASC 820, Fair Value Measurements and Disclosures, established a formal framework for measuring fair values of assets and liabilities in financial statements. ASC 820 also established a formal fair value hierarchy based on the inputs used to measure fair value. The hierarchy gives the highest priority to Level 1 measurements and the lowest priority to Level 3 measurements. The Company has classified its assets and liabilities into these levels depending upon the data relied on to determine the fair values. For further information regarding the fair value hierarchy, refer to Note 13 of the Notes to the Consolidated Financial Statements in the 2011 Form 10-K.

Non-Financial Assets and Liabilities

The Company discloses or recognizes its non-financial assets and liabilities, such as impairments of long-lived assets, at fair value on a nonrecurring basis. As none of the Company s non-financial assets and liabilities were impaired as of September 30, 2012 and 2011 and no other assets or liabilities were required to be measured at fair value on a non-recurring basis, additional disclosures are not provided.

Financial Assets and Liabilities

The Company s financial assets and liabilities are measured at fair value on a recurring basis. The following fair value hierarchy table presents information about the Company s financial assets and liabilities measured at fair value on a recurring basis:

(In thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	September 30, 2012
Assets				
Deferred Compensation Plan	$ 11,462	$	$	**$ 11,462**
Derivative Contracts		12,471	53,631	**66,102**
Total Assets	$ 11,462	$ 12,471	$ 53,631	**$ 77,564**
Liabilities				
Deferred Compensation Plan	$ 22,668	$	$	**$ 22,668**
Derivative Contracts			8,809	**8,809**
Total Liabilities	$ 22,668	$	$ 8,809	**$ 31,477**

(In thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	December 31, 2011
Assets				
Deferred Compensation Plan	$ 10,838	$	$	$ 10,838

Derivative Contracts						195,512		195,512
Total Assets	$	10,838	$		$	195,512	$	206,350
Liabilities								
Deferred Compensation Plan	$	20,187	$		$		$	20,187
Derivative Contracts						385		385
Total Liabilities	$	20,187	$		$	385	$	20,572

The Company s investments associated with its Deferred Compensation Plan consist of mutual funds and deferred shares of the Company s common stock that are publicly traded and for which market prices are readily available.

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The derivative contracts were measured based on quotes from the Company s counterparties. Such quotes have been derived using an income approach that considers various inputs including current market and contractual prices for the underlying instruments, quoted forward prices for natural gas and crude oil, basis differentials, volatility factors and interest rates, such as a LIBOR curve for a similar length of time as the derivative contract term, as applicable. These estimates are verified using relevant NYMEX futures contracts or are compared to multiple quotes obtained from counterparties for reasonableness. The determination of the fair values presented above also incorporates a credit adjustment for non-performance risk. The Company measured the non-performance risk of its counterparties by reviewing credit default swap spreads for the various financial institutions in which it has derivative transactions, while non-performance risk of the Company is evaluated using a market credit spread provided by the Company s bank.

The significant unobservable inputs for Level 3 derivative contracts include basis differentials and volatility factors. An increase (decrease) in these unobservable inputs would result in an increase (decrease) in fair value, respectively. The Company does not have access to the specific assumptions used in its counterparties valuation models. Consequently, additional disclosures regarding significant Level 3 unobservable inputs were not provided.

The following table sets forth a reconciliation of changes in the fair value of financial assets and liabilities classified as Level 3 in the fair value hierarchy:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands)	**2012**	**2011**	**2012**	**2011**
Balance at beginning of period	**$ 129,213**	$ 48,415	**$ 195,127**	$ 14,746
Total Gains / (Losses) (Realized or Unrealized):				
Included in Earnings *(1)*	**56,990**	22,488	**183,418**	47,934
Included in Other Comprehensive Income	**(85,466)**	75,591	**(153,008)**	110,146
Settlements	**(55,915)**	(22,552)	**(181,100)**	(48,884)
Transfers In and/or Out of Level 3			**385**	
Balance at end of period	**$ 44,822**	$ 123,942	**$ 44,822**	$ 123,942

(1) *Unrealized losses of $0.1 million and $0.1 million for the three months ended September 30, 2012 and 2011, respectively, and unrealized losses of $0.4 million and $1.0 million for the nine months ended September 30, 2012 and 2011, respectively, were included in Natural Gas Revenues in the Condensed Consolidated Statement of Operations.*

There were no transfers between Level 1 and Level 2 measurements for the nine months ended September 30, 2012 and 2011.

Fair Value of Other Financial Instruments

The estimated fair value of financial instruments is the amount at which the instrument could be exchanged currently between willing parties. The carrying amounts reported in the Condensed Consolidated Balance Sheet for cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to the short-term maturities of these instruments.

The fair value of long-term debt is the estimated cost to acquire the debt, including a credit spread for the difference between the issue rate and the period end market rate. The credit spread is the Company s default or repayment risk. The credit spread (premium or discount) is determined by comparing the Company s fixed-rate notes and credit facility to new issuances (secured and unsecured) and secondary trades of similar size and credit statistics for both public and private debt. The fair value of all fixed-rate notes and the credit facility is based on interest rates currently available to the Company. The Company s long-term debt is valued using an income approach and classified as Level 3 in the fair value hierarchy.

The Company uses available market data and valuation methodologies to estimate the fair value of debt. The carrying amounts and fair values of long-term debt are as follows:

	September 30, 2012		December 31, 2011	
(In thousands)	**Carrying Amount**	**Estimated Fair Value**	**Carrying Amount**	**Estimated Fair Value**
Long-Term Debt	**$ 1,062,000**	**$ 1,195,717**	$ 950,000	$ 1,082,531
Current Maturities	**(75,000)**	**(78,095)**		
Long-Term Debt, excluding Current Maturities	**$ 987,000**	**$ 1,117,622**	$ 950,000	$ 1,082,531

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10. ACCUMULATED COMPREHENSIVE INCOME / (LOSS)

Changes in the components of Accumulated Other Comprehensive Income / (Loss), net of taxes, for the nine months ended September 30, 2012 were as follows:

(In thousands)	Net Gains / (Losses) on Cash Flow Hedges	Defined Benefit Pension and Postretirement Plans	Total
Balance at December 31, 2011	$ 121,358	$ (16,811)	$ 104,547
Net change in unrealized gain on cash flow hedges, net of taxes of $54,299	(85,852)		(85,852)
Net change in defined benefit pension and postretirement plans, net of taxes of $(5,433)		8,563	8,563
Balance at September 30, 2012	**$ 35,506**	**$ (8,248)**	**$ 27,258**

11. PENSION AND OTHER POSTRETIREMENT BENEFITS

The components of net periodic benefit costs, included in General and Administrative Expense in the Condensed Consolidated Statement of Operations, were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands)	**2012**	**2011**	**2012**	**2011**
Qualified and Non-Qualified Pension Plans				
Interest Cost	**$**	$ 650	**$ 922**	$ 2,251
Expected Return on Plan Assets		(945)	**(1,748)**	(3,265)
Settlement		2,446	**7,111**	2,446
Amortization of Prior Service Cost		228	**221**	862
Amortization of Net Loss		2,373	**13,083**	8,498
Net Periodic Pension Cost	**$**	$ 4,752	**$ 19,589**	$ 10,792
Postretirement Benefits				
Current Period Service Cost	$ **234**	$ 335	**$ 1,280**	$ 1,004
Interest Cost	**351**	467	**1,187**	1,402
Amortization of Net Loss	**132**	140	**692**	422
Amortization of Net Obligation at Transition		158		474
Total Postretirement Benefit Cost	**$ 717**	$ 1,100	**$ 3,159**	$ 3,302

Termination and Amendment of Qualified Pension Plan

In July 2010, the Company notified its employees of its plan to terminate its qualified pension plan, with the plan and its related trust to be liquidated following appropriate filings with the Pension Benefit Guaranty Corporation and Internal Revenue Service, effective September 30, 2010. The Company then amended and restated the qualified pension plan to freeze benefit accruals, to provide for termination of the plan, to allow for an early retirement enhancement to be available to all active participants as of September 30, 2010 regardless of their age and years of service as of that date, and to make certain changes that were required or made desirable as a result of developments in the law.

On March 14, 2012, the Internal Revenue Service provided the Company with a favorable determination letter for the termination of the Company s qualified pension plan. In June and July 2012, the Company made final contributions of $9.6 million and $3.6 million, respectively, to fund the liquidation of the trust under the qualified pension plan. As of September 30, 2012, the benefit obligations associated with the qualified pension plan were fully satisfied.

For further information regarding termination and amendment of the Company s pension plans, refer to Note 5 of the Notes to the Consolidated Financial Statements in the 2011 Form 10-K.

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12. STOCK-BASED COMPENSATION

Stock-based compensation expense during the first nine months of 2012 and 2011 was $23.4 million and $29.3 million, respectively, and is included in General and Administrative Expense in the Condensed Consolidated Statement of Operations. Stock-based compensation expense in the third quarter of 2012 and 2011 was $10.4 million and $10.0 million, respectively.

Restricted Stock Awards

During the first nine months of 2012, 4,350 restricted stock awards were granted with a weighted-average grant date per share value of $32.18. The fair value of restricted stock grants is based on the average of the high and low stock price on the grant date. The Company used an annual forfeiture rate assumption of 6.0% for purposes of recognizing stock-based compensation expense for restricted stock awards.

Restricted Stock Units

During the first nine months of 2012, 38,304 restricted stock units were granted to non-employee directors of the Company with a grant date per share value of $36.55. The fair value of these units is measured at the average of the high and low stock price on grant date and compensation expense is recorded immediately. These units immediately vest and will be issued when the director ceases to be a director of the Company.

Stock Appreciation Rights

During the first nine months of 2012, 120,442 stock appreciation rights (SARs) were granted to employees. These awards allow the employee to receive common stock of the Company equal to the intrinsic value over the $35.18 strike price during the contractual term of seven years. The Company calculates the fair value using a Black-Scholes model. The assumptions used in the Black-Scholes fair value calculation on the date of grant for SARs are as follows:

Weighted-Average Value per Stock Appreciation Right	
Granted During the Period	$16.31
Assumptions	
Stock Price Volatility	55.3%
Risk Free Rate of Return	0.9%
Expected Dividend Yield	0.3%
Expected Term (in years)	5.0

Performance Share Awards

During the first nine months of 2012, three types of performance share awards were granted to employees for a total of 518,602 performance shares, which included 401,141 performance share awards based on performance conditions measured against the Company s internal performance metrics and 117,461 performance share awards based on market conditions. The Company used an annual forfeiture rate assumption ranging from 0% to 6% for purposes of recognizing stock-based compensation expense for all performance share awards. The performance period for the awards granted in 2012 commenced on January 1, 2012 and ends on December 31, 2014. Refer to Note 11 of the Notes to the Consolidated Financial Statements in the 2011 Form 10-K for further description of the various types of performance share awards.

Awards Based on Performance Conditions. The performance awards based on internal metrics had a grant date per share value of $35.18, which is based on the average of the high and low stock price on the grant date. These awards represent the right to receive up to 100% of the award in shares of common stock. Of the 401,141 performance awards based on internal metrics, 117,461 shares have a three-year graded performance period. For these shares, one-third of the shares are issued on each anniversary date following the date of grant, provided that the Company has $100 million or more of operating cash flow for the year preceding the vesting date. If the Company does not meet this metric for the applicable period, then the portion of the performance shares that would have been issued on that date will be forfeited.

For the remaining 283,680 performance awards, the actual number of shares issued at the end of the performance period will be determined based on the Company s performance against three performance criteria set by the Company s Compensation Committee. An employee will earn one-third of the award granted for each internal performance metric that the Company meets at the end of the

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performance period. These performance criteria are based on the Company s average production, average finding costs and average reserve replacement over the three-year performance period.

Based on the Company s probability assessment at September 30, 2012, it is considered probable that criteria for these awards will be met.

Awards Based on Market Conditions. The 117,461 performance shares based on market conditions are earned, or not earned, based on the comparative performance of the Company s common stock measured against sixteen other companies in the Company s peer group over a three-year performance period. These performance shares have both an equity and liability component. The equity portion of the 2012 awards was valued on the grant date (February 16, 2012) and was not marked to market. The liability portion of the awards was valued as of September 30, 2012 on a mark-to-market basis.

The following assumptions were used to value the equity and liability components of the Company s performance share awards based on market conditions using a Monte Carlo model:

	Grant Date	**September 30, 2012**
Value per Share	$28.31	$29.39 - $44.56
Assumptions:		
Stock Price Volatility	46.7%	36.2% - 50.7%
Risk Free Rate of Return	0.4%	0.1% - 0.3%
Expected Dividend Yield	0.2%	0.2%

Supplemental Employee Incentive Plan

On May 1, 2012, the Company s Board of Directors adopted a new Supplemental Employee Incentive Plan (Plan) to replace the previously adopted supplemental employee incentive plan that expired on June 30, 2012. There were no amounts paid under the expired plan. The Plan commenced on July 1, 2012 and is intended to provide a compensation tool tied to stock market value creation to serve as an incentive and retention vehicle for full-time, non-officer employees by providing for cash payments in the event the Company s common stock reaches a specified trading price. The Plan is accounted for as a liability award under ASC 718, Compensation Stock Compensation. The Company recognized stock-based compensation expense / (benefit) of $1.6 million and ($0.1) million for the three and nine months ended September 30, 2012, respectively, which is included in General and Administrative expense in the Condensed Consolidated Statement of Operations.

The Plan provides for a payout if, for any 20 trading days out of any 60 consecutive trading days, the closing price per share of the Company s common stock equals or exceeds the price goal of $50 per share by June 30, 2014 (interim trigger date) or $75 per share by June 30, 2016 (final trigger date). Under the Plan, each eligible employee may receive (upon approval by the Compensation Committee) a distribution of 20% of base salary if the interim trigger is met or 50% of base salary if the final trigger is met (or an incremental 30% of base salary if the Company paid interim distributions upon achievement of the interim trigger).

In accordance with the Plan, in the event the interim or final trigger date occurs between July 1, 2012 and December 31, 2014, 25% of the total distribution will be paid immediately and the remaining 75% will be deferred and paid at a future date as described in the Plan. For final trigger dates occurring between January 1, 2015 and June 30, 2016, total distribution will be paid immediately.

The Compensation Committee can increase any of the payments as applied to any employee if desired. Any deferred portion will only be paid if the participant is employed by the Company, or has terminated employment by reason of retirement, death or disability (as provided in the Plan). Payments are subject to certain other restrictions contained in the Plan.

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13. ASSET RETIREMENT OBLIGATION

Activity related to the Company s asset retirement obligation is as follows:

(In thousands)		
Balance at December 31, 2011	$	60,142
Liabilities incurred		1,731
Liabilities settled		(1,050)
Accretion expense		2,283
Change in Estimate		(37)
Balance at September 30, 2012	$	**63,069**

14. INCREASE IN AUTHORIZED SHARES

In May 2012, the stockholders of the Company approved an increase in the authorized number of shares of common stock from 240 million to 480 million shares.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of

Cabot Oil & Gas Corporation:

We have reviewed the accompanying condensed consolidated balance sheet of Cabot Oil & Gas Corporation and its subsidiaries (the Company) as of September 30, 2012, and the related condensed consolidated statements of operations and comprehensive income for the three and nine month periods ended September 30, 2012 and 2011, and the condensed consolidated statement of cash flows for the nine month periods ended September 30, 2012 and 2011. These interim financial statements are the responsibility of the Company s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2011, and the related consolidated statements of operations, stockholders equity, comprehensive income and of cash flows for the year then ended (not presented herein), and in our report dated February 28, 2012, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet information as of December 31, 2011, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

Houston, Texas

October 26, 2012

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ITEM 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following review of operations for the three and nine month periods ended September 30, 2012 and 2011 should be read in conjunction with our Condensed Consolidated Financial Statements and the Notes included in this Form 10-Q and with the Consolidated Financial Statements, Notes and Management s Discussion and Analysis included in the Cabot Oil & Gas Corporation Annual Report on Form 10-K for the year ended December 31, 2011 (Form 10-K).

On January 3, 2012, the Board of Directors declared a 2-for-1 split of our common stock in the form of a stock dividend. The stock dividend was distributed on January 25, 2012 to shareholders of record as of January 17, 2012. All common stock accounts and per share data have been retroactively adjusted to give effect to the 2-for-1 split of our common stock.

Overview

On an equivalent basis, our production for the nine months ended September 30, 2012 increased by 42% compared to the nine months ended September 30, 2011. For the nine months ended September 30, 2012, we produced 188.9 Bcfe compared to 132.7 Bcfe for the nine months ended September 30, 2011. Natural gas production was 178.4 Bcf and crude oil/condensate/NGL production was 1,760 Mbbls for the first nine months of 2012. Natural gas production increased by 40% when compared to the first nine months of 2011, which had production of 127.2 Bcf. This increase was primarily a result of increased production in the Marcellus shale associated with our drilling program and infrastructure installation and upgrades in Susquehanna County, Pennsylvania. Partially offsetting the natural gas production increase in the Marcellus shale were decreases in natural gas production in east Texas due to reduced drilling activity and normal production declines along with the sale of oil and gas properties in Colorado, Utah and Wyoming in the fourth quarter of 2011. Crude oil/condensate/NGL production increased by 91%, to 1,760 Mbbls, when compared to the first nine months of 2011, which had production of 920 Mbbls, primarily due to our focus on liquids projects associated with our Eagle Ford shale drilling program in south Texas and the Marmaton oil play in Oklahoma.

Our average realized natural gas price for the first nine months of 2012 was $3.57 per Mcf, 23% lower than the $4.64 per Mcf price realized in the first nine months of 2011. Our average realized crude oil price for the first nine months of 2012 was $100.30 per Bbl, 12% higher than the $89.69 per Bbl price realized in the first nine months of 2011. These realized prices include realized gains and losses resulting from commodity derivatives. For information about the impact of these derivatives on realized prices, refer to Results of Operations below. Commodity prices are determined by many factors that are outside of our control. Historically, commodity prices have been volatile, and we expect them to remain volatile. Commodity prices are affected by changes in market supply and demand, which are impacted by overall economic activity, weather, pipeline capacity constraints, inventory storage levels, basis differentials and other factors. As a result, we cannot accurately predict future natural gas, NGL and crude oil prices and, therefore, we cannot determine with any degree of certainty what effect increases or decreases will have on our capital program, production volumes or future revenues.

Operating revenues for the nine months ended September 30, 2012 increased by $122.8 million, or 17%, from the nine months ended September 30, 2011. Natural gas revenues, excluding unrealized gains/losses from the change in fair value of our derivatives not designated as hedges, increased by $50.3 million, or 9%, for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 as the increase in natural gas production more than offset the lower realized natural gas prices. Crude oil and condensate revenues increased by $85.5 million, or 107%, for the first nine months of 2012 as compared to the first nine months of 2011, due to increased crude oil production and realized crude oil prices. Brokered natural gas revenues decreased by $15.1 million, or 39%, due to a lower sales price and brokered volumes.

In addition to production volumes and commodity prices, finding and developing sufficient amounts of crude oil and natural gas reserves at economical costs are critical to our long-term success. For 2012, we expect to spend approximately $900 million to $950 million in capital and exploration expenditures, using proceeds from the sale of assets to supplement our cash flows from operations in order to fund incremental capital and exploration expenditures above previously budgeted amounts. We believe our existing cash on hand, operating cash flows, borrowings under our credit facility, if required, and proceeds from the sale of assets will be more than sufficient to fund our capital and exploration spending in the current year. We will continue to assess the natural gas and crude oil price environment along with our liquidity position and may increase or decrease our capital and exploration expenditures accordingly. For the nine months ended September 30, 2012, we invested approximately $712.9 million in our exploration and development efforts.

During the first nine months of 2012, we drilled 104 gross wells (94 development, four exploratory and six extension wells) with a success rate of 97% compared to 85 gross wells (73 development, five exploratory and seven extension wells) with a success rate of 99% for the comparable period of the prior year. For the full year of 2012, we plan to drill approximately 150 to 170 gross wells.

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Our 2012 strategy will remain consistent with 2011. We remain focused on pursuing drilling opportunities that provide more predictable results on our accumulated acreage position. Additionally, we intend to maintain spending discipline and manage our balance sheet in an effort to ensure sufficient liquidity, including cash resources and available credit. For 2012, we have allocated our planned program for capital and exploration expenditures primarily to the Marcellus shale in northeast Pennsylvania, the Eagle Ford oil shale in south Texas, including a portion toward the Pearsall shale (below the Eagle Ford oil shale), and the Marmaton oil play in Oklahoma. We believe these strategies are appropriate for our portfolio of projects and the current commodity pricing environment and will continue to add shareholder value over the long-term.

In June 2012, we sold a 35% non-operated working interest associated with certain of our Pearsall shale undeveloped leaseholds in south Texas. For further information, please refer to Divestitures under Note 2 in the Notes to the Condensed Consolidated Financial Statements.

The preceding paragraphs, discussing our strategic pursuits and goals, contain forward-looking information. Please read Forward-Looking Information for further details.

Financial Condition

Capital Resources and Liquidity

Our primary sources of cash for the nine months ended September 30, 2012 were funds generated from the sale of natural gas and crude oil production (including realizations from our derivative instruments), proceeds from the sale of assets and net borrowings under our credit facility. These cash flows were primarily used to fund our capital and exploration expenditures, contributions to our pension plan and payment of dividends. See below for additional discussion and analysis of cash flow.

Operating cash flow fluctuations are substantially driven by commodity prices, changes in our production volumes and operating expenses. Prices for natural gas and crude oil have historically been and continue to be volatile, including seasonal influences characterized by peak demand and higher prices in the winter heating season; however, the impact of other risks and uncertainties, as described in our Form 10-K and other filings with the Securities and Exchange Commission, have also influenced prices throughout the recent years. In addition, fluctuations in cash flow may result in an increase or decrease in our capital and exploration expenditures. See Results of Operations for a review of the impact of prices and volumes on revenues.

Our working capital is also substantially influenced by variables discussed above. From time to time, our working capital will reflect a surplus, while at other times it will reflect a deficit. This fluctuation is not unusual. We believe we have adequate availability under our credit facility and liquidity available to meet our working capital requirements.

	Nine Months Ended September 30,	
(In thousands)	**2012**	**2011**
Cash Flows Provided by Operating Activities	$ **455,112**	$ 375,366

Cash Flows Used in Investing Activities		**(540,946)**		(586,878)
Cash Flows Provided by Financing Activities		**93,424**		218,491
Net Increase / (Decrease) in Cash and Cash Equivalents	**$**	**7,590**	$	6,979

***Operating Activities*.** Net cash provided by operating activities in the first nine months of 2012 increased by $79.7 million over the first nine months of 2011. This increase was primarily due to favorable changes in working capital and long-term assets and liabilities and higher operating revenues partially offset by higher operating expenses (excluding non-cash expenses). The increase in operating revenues was primarily due to an increase in equivalent production and higher realized crude oil prices partially offset by lower realized natural gas prices. Equivalent production volumes increased by 42% for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011 as a result of higher natural gas and crude oil production. Average realized crude oil prices increased by 12% compared to the same period while average realized natural gas prices decreased by 23% for the first nine months of 2012 compared to the first nine months of 2011.

See Results of Operations for additional information relative to commodity price, production and operating expense movements. We are unable to predict future commodity prices and, as a result, cannot provide any assurance about future levels of net cash provided by operating activities. Realized prices may decline in future periods.

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***Investing Activities*.** Cash flows used in investing activities decreased by $45.9 million for the first nine months of 2012 compared to the first nine months of 2011. The decrease was primarily due an increase of $50.6 million in proceeds from sale of assets, partially offset by $4.5 million of capital contributions associated with our equity method investment in Constitution Pipeline Company, LLC (Constitution).

***Financing Activities*.** Cash flows provided by financing activities decreased by $125.1 million from the first nine months of 2011 to the first nine months of 2012. This decrease was primarily due to $118.0 million lower net borrowings ($50.0 million decrease in borrowings and $68.0 million increase in repayments of debt), $4.0 million higher debt issuance costs associated with our amended credit facility and $3.2 million higher dividend payments.

In May 2012, we amended our revolving credit facility to adjust the margins associated with borrowings under the facility and extend the maturity date from September 2015 to May 2017. The credit facility, as amended, provides for an available credit line of $900 million and contains a $500 million accordion feature whereby we may increase the available credit line to $1.4 billion, if one or more of the existing banks or new banks agree to provide such increased commitment amount. As of September 30, 2012, the borrowing base under our amended credit facility was $1.7 billion.

At September 30, 2012, we had $300.0 million of borrowings outstanding under the amended credit facility at a weighted-average interest rate of 2.3% and $599.0 million available for future borrowings.

We were in compliance in all material respects with our debt covenants as of September 30, 2012.

We strive to manage our debt at a level below the available credit line in order to maintain borrowing capacity. Our revolving credit facility includes a covenant limiting our total debt. Management believes that, with internally generated cash flow from operations, existing cash on hand, proceeds from the sale of assets and availability under our revolving credit facility, if required, we have the capacity to finance our spending plans, service our debt obligations as they become due and maintain our strong financial position.

Capitalization

Information about our capitalization is as follows:

(In thousands)	**September 30, 2012**	**December 31, 2011**
Debt *(1)*	**$ 1,062,000**	$ 950,000
Stockholders Equity	**2,100,287**	2,104,768
Total Capitalization	**$ 3,162,287**	$ 3,054,768
Debt to Capitalization	**34%**	31%

Cash and Cash Equivalents	**$**	**37,501**	$	29,911

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(1) Includes $75.0 million of current portion of long-term debt at September 30, 2012 and $300.0 million and $188.0 million of borrowings outstanding under our revolving credit facility at September 30, 2012 and December 31, 2011, respectively.

During the nine months ended September 30, 2012, we paid dividends of $12.6 million ($0.06 per share) on our common stock. A regular dividend has been declared for each quarter since we became a public company in 1990.

Capital and Exploration Expenditures

On an annual basis, we generally fund most of our capital and exploration activities, excluding any significant oil and gas property acquisitions, with cash generated from operations and, if necessary, borrowings under our revolving credit facility. We budget these capital expenditures based on our current estimate of future commodity prices and projected cash flows for the year.

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The following table presents major components of capital and exploration expenditures:

(In thousands)	Nine Months Ended September 30, 2012	2011
Capital Expenditures		
Drilling and Facilities	$ **602,820**	$ 561,017
Leasehold Acquisitions	**74,426**	60,922
Pipeline and Gathering	**(365)**	7,218
Other	**6,457**	6,452
	683,338	635,609
Exploration Expense	**29,548**	31,090
Total	$ **712,886**	$ 666,699

For the full year of 2012, we plan to drill approximately 150 to 170 gross wells. Our 2012 drilling program includes between $900 million to $950 million in total planned capital and exploration expenditures, using proceeds from the sale of assets to supplement our cash flows from operations in order to fund incremental capital and exploration expenditures above previously budgeted amounts. See Overview for additional information regarding the current year drilling program. We will continue to assess the natural gas and crude oil price environment along with our liquidity position and may increase or decrease our capital and exploration expenditures accordingly.

Contractual Obligations

We have various contractual obligations in the normal course of our operations. For further information, please refer to Transportation Agreements under Note 7 in the Notes to the Condensed Consolidated Financial Statements for changes in our commitments for the first nine months of 2012. There have been no other material changes to our contractual obligations described under Gas Transportation Agreements , Drilling Rig Commitments , Hydraulic Fracturing Services Commitments and Lease Commitments as disclosed in Note 7 in the Notes to Consolidated Financial Statements included in our 2011 Form 10-K.

In February 2012, we entered into a Precedent Agreement with Constitution, at that time a wholly owned subsidiary of Williams Partners L.P., to develop and construct a 120 mile large diameter pipeline to transport our production in northeast Pennsylvania to both the New England and New York markets. In April 2012, we entered into an Amended and Restated Limited Liability Company Agreement with Constitution. Refer to Note 5 in the Notes to Condensed Consolidated Financial Statements for further details.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted and adopted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. See our 2011 Form 10-K for further discussion of our critical accounting policies.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The amendments in this update generally represent clarifications of Topic 820, but also include some instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. This update results in common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and IFRS. The amendments are effective for interim and annual periods beginning after December 15, 2011 and are to be applied prospectively. This update did not have any impact on our consolidated financial position, results of operations or cash flows.

In June 2011, the FASB issued ASU No. 2011-05, Presentation of Comprehensive Income. ASU No. 2011-05 was amended in December 2011 by ASU No. 2011-12, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU No. 2011-05. ASU No. 2011-12 defers only those changes in ASU No. 2011-05 that relate to the presentation of reclassification adjustments. All other requirements in ASU No. 2011-05 are not affected by ASU No. 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. ASU No. 2011-05 and 2011-12 are effective for fiscal years (including interim

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periods) beginning after December 15, 2011. We elected to present two separate but consecutive financial statements. These updates did not have any impact on our consolidated financial position, results of operations or cash flows.

In December 2011, the FASB issued ASU No. 2011-11, Disclosures about Offsetting Assets and Liabilities. The amendments in this update require enhanced disclosures around financial instruments and derivative instruments that are either (1) offset in accordance with either Accounting Standards Codification (ASC) 210-20-45 or ASC 815-10-45 or (2) subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with either ASC 210-20-45 or ASC 815-10-45. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The amendments are effective during interim and annual periods beginning on or after January 1, 2013. This guidance will primarily impact our disclosures associated with our commodity derivatives. We do not expect this guidance to have any impact on our consolidated financial position, results of operations or cash flows.

Results of Operations

Third Quarters of 2012 and 2011 Compared

We reported net income in the third quarter of 2012 of $36.6 million, or $0.17 per share, compared to $28.5 million, or $0.14 per share in the third quarter of 2011. The increase in net income was primarily due to an increase in equivalent production and higher realized crude oil prices partially offset by lower realized natural gas prices and higher operating costs.

Revenue, Price and Volume Variances

Below is a discussion of revenue, price and volume variances.

	Three Months Ended September 30,		Variance	
Revenue Variances (In thousands)	**2012**	**2011**	**Amount**	**Percent**
Natural Gas *(1)*	$ **232,045**	$ 218,585	$ 13,460	6%
Crude Oil and Condensate	**57,870**	33,158	24,712	75%
Brokered Natural Gas	**5,238**	9,467	(4,229)	(45)%
Other	**1,870**	971	899	93%

(1) Natural Gas Revenues exclude the unrealized loss of $0.1 million and $0.1 million from the change in fair value of our derivatives not designated as hedges in 2012 and 2011, respectively.

	Three Months Ended September 30,		Variance		Increase (Decrease)
	2012	**2011**	**Amount**	**Percent**	**(In thousands)**

Price Variances								
Natural Gas *(1)*	$	**3.68**	$	4.58	$	(0.90)	(20)%	$ (55,170)
Crude Oil and Condensate *(2)*	$	**101.34**	$	86.89	$	14.45	17%	8,283
Total								$ (46,887)
Volume Variances								
Natural Gas (Mmcf)		**62,692**		47,707		14,985	31%	$ 68,630
Crude Oil and Condensate (Mbbl)		**571**		382		189	49%	16,429
Total								$ 85,059

(1) These prices include the realized impact of derivative instrument settlements, which increased the price by $0.91 per Mcf in 2012 and $0.44 per Mcf in 2011.

(2) These prices include the realized impact of derivative instrument settlements, which increased the price by $6.65 per Bbl in 2012 and $3.62 per Bbl in 2011.

Natural Gas Revenues

The increase in natural gas revenues of $13.5 million, excluding the impact of unrealized losses, is due to increased production during the third quarter of 2012, partially offset by lower realized natural gas prices. The increase in production was primarily a result of higher production in the Marcellus shale associated with our drilling program and infrastructure installation and upgrades in Susquehanna County, Pennsylvania. Partially offsetting the increase in natural gas production in the Marcellus shale were decreases in natural gas production in east Texas due to reduced drilling activity and normal production declines along with the sale of oil and gas properties in Colorado, Utah and Wyoming in the fourth quarter of 2011.

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Crude Oil and Condensate Revenues

The increase in crude oil and condensate revenues of $24.7 million is primarily due to our focus on liquids projects associated with our Eagle Ford shale drilling program in south Texas and the Marmaton oil play in Oklahoma and higher realized oil prices.

Brokered Natural Gas Revenue and Cost

	Three Months Ended September 30,				Variance			Price and Volume Variances (In thousands)	
		2012		2011		Amount	Percent		
Brokered Natural Gas Sales									
Sales Price ($/Mcf)	**$**	**3.28**	$	4.99	$	(1.71)	(34)%	$	(2,712)
Volume Brokered (Mmcf)	**x**	**1,595**	x	1,899		(304)	(16)%		(1,517)
Brokered Natural Gas Revenues (In thousands)	**$**	**5,238**	$	9,467				$	(4,229)
Brokered Natural Gas Purchases									
Purchase Price ($/Mcf)	**$**	**2.67**	$	4.32	$	(1.65)	(38)%	$	£m

£m

£m

30 September 2011

Held-for-trading (HFT)

8,434

20,120

47,621

4,216

27,511

4,666

112,568

24,123

Designated as at fair value

1

-

140

4

7

10

162

1

Available-for-sale

13,328

20,032
28,976
17,268
28,463
2,334
110,401
41,091

Loans and receivables

10
-
-
274
5,764
478
6,526
5,447

21,773
40,152
76,737
21,762
61,745
7,488
229,657
70,662

Of which US agencies

-
5,311
-
-
27,931
-
33,242
30,272

Short positions (HFT)

(2,896)
(12,763)
(21,484)
(2,043)
(4,437)
(1,680)
(45,303)
(895)

Available-for-sale

Gross unrealised gains

1,090
1,240

1,331
310
1,117
81
5,169
1,242

Gross unrealised losses

-
-
(989)
(1,039)
(2,371)
(24)
(4,423)
(3,114)

Risk and balance sheet management (continued)

Risk management: Credit risk: Debt securities (continued)

	Central and local government				Other			Of
					financial			which
	UK	US	Other	Banks	institutions	Corporate	Total	ABS
31 December 2010	£m	£m	£m	£m	£m	£m	£m	£m
Held-for-trading	5,097	15,648	42,828	5,486	23,711	6,099	98,869	21,988
Designated as at fair value	1	117	262	4	8	10	402	119
Available-for-sale	8,377	22,244	32,865	16,982	29,148	1,514	111,130	42,515
Loans and receivables	11	-	-	1	6,686	381	7,079	6,203
	13,486	38,009	75,955	22,473	59,553	8,004	217,480	70,825
Of which US agencies	-	6,811	-	-	21,686	-	28,497	25,375
Short positions (HFT)	(4,200)	(10,943)	(18,913)	(1,844)	(3,356)	(1,761)	(41,017)	(1,335)
Available-for-sale								
Gross unrealised gains	349	525	700	143	827	51	2,595	1,057
Gross unrealised losses	(10)	(2)	(618)	(786)	(2,626)	(55)	(4,097)	(3,396)

Key points

· Held-for-trading bonds increased by £13.7 billion of which £12.6 billion relates to government bonds (principally G10).

· Whilst the Group's AFS portfolio decreased by £0.7 billion, UK government bonds increased by £5.0 billion, principally in the Group's liquidity portfolio.

The table below analyses debt securities by issuer and external ratings; ratings are based on the lowest of S&P, Moody's and Fitch.

	Central and local government				Other financial				Of which
	UK	US	Other	Banks	institutions	Corporate	Total		ABS
30 September 2011	£m	£m	£m	£m	£m	£m	£m	% of total	£m
AAA	21,773	27	43,712	9,363	14,120	553	89,548	39	18,771
AA to AA+	-	40,094	4,247	4,279	31,785	661	81,066	35	35,954
A to AA-	-	9	25,043	5,087	4,783	1,894	36,816	16	5,670
BBB- to A-	-	-	2,460	2,032	3,873	2,104	10,469	5	4,431
Non-investment grade	-	-	1,242	709	5,242	1,778	8,971	4	4,619
Unrated	-	22	33	292	1,942	498	2,787	1	1,217
	21,773	40,152	76,737	21,762	61,745	7,488	229,657	100	70,662
31 December 2010									
AAA	13,486	38,009	44,123	10,704	39,388	878	146,588	67	51,235
AA to AA+	-	-	18,025	3,511	6,023	616	28,175	13	6,335
A to AA-	-	-	9,138	4,926	2,656	1,155	17,875	8	3,244
BBB- to A-	-	-	2,845	1,324	3,412	2,005	9,586	5	3,385
Non-investment grade	-	-	1,770	1,528	5,522	2,425	11,245	5	4,923
Unrated	-	-	54	480	2,552	925	4,011	2	1,703
	13,486	38,009	75,955	22,473	59,553	8,004	217,480	100	70,825

Risk and balance sheet management (continued)

Risk management: Credit risk: Debt securities (continued)

Key points

· The decrease in AAA rated debt securities relates to the downgrading of US government and agencies to AA+ by S&P in August 2011.

· The proportion of debt securities rated A to AA- increased to 16%, principally reflecting the Japanese government downgrade in January 2011.

· Non-investment grade and unrated debt securities now account for 5% of the debt securities portfolio down from 7% at the start of the year.

Asset-backed securities

	RMBS (1)									
	Government sponsored or similar (2)	Prime	Non-conforming	Sub-prime	MBS covered bond	CMBS (3)	CDOs (4)	CLOs (5)	Other ABS (6)	Total
30 September 2011	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
AAA	4,391	4,152	1,509	144	3,462	893	194	2,198	1,828	18,771
AA to AA+	31,037	117	111	97	1,162	839	125	1,496	970	35,954
A to AA-	137	603	124	175	1,680	1,326	166	569	890	5,670
BBB- to A-	-	147	295	59	1,553	383	92	601	1,301	4,431
Non-investment grade	-	768	676	486	-	327	1,516	170	676	4,619
Unrated	-	146	47	213	-	67	134	331	279	1,217
	35,565	5,933	2,762	1,174	7,857	3,835	2,227	5,365	5,944	70,662
Of which in Non-Core	-	269	463	276	-	1,158	1,953	4,698	1,976	10,793
31 December 2010										
AAA	28,835	4,355	1,754	317	7,107	2,789	444	2,490	3,144	51,235
AA to AA+	1,529	147	144	116	357	392	567	1,786	1,297	6,335
A to AA-	-	67	60	212	408	973	296	343	885	3,244
BBB- to A-	-	82	316	39	-	500	203	527	1,718	3,385
Non-investment grade	-	900	809	458	-	296	1,863	332	265	4,923
Unrated	-	196	52	76	-	-	85	596	698	1,703
	30,364	5,747	3,135	1,218	7,872	4,950	3,458	6,074	8,007	70,825

Notes:

(1) Residential mortgage-backed securities.
(2) Includes US agency and Dutch government guaranteed securities.
(3) Commercial mortgage-backed securities.
(4) Collateralised debt obligations.
(5) Collateralised loan obligations.
(6) Other ABS includes £1.4 billion (31 December 2010 - £1.9 billion) of covered bonds.

For analyses of ABS by geography and measurement classification, refer to Appendix 3.

Risk and balance sheet management (continued)

Risk management: Credit risk: Available-for-sale debt securities and reserves

The table below analyses available-for-sale (AFS) debt securities by issuer and related AFS reserves, gross and net of tax, for countries exceeding £0.5 billion, together with the total in aggregate of those individually less than £0.5 billion.

	30 September 2011							31 December 2010			
	Central and local government £m	Banks £m	Other financial institutions £m	Corporate £m	Total £m	Of which ABS £m	AFS reserves (gross) £m	Central and local government £m	Banks £m	Other financial institutions £m	Corporate £m
US	20,032	394	16,710	169	37,305	19,907	523	22,244	704	15,973	65
UK	13,328	4,053	996	891	19,268	3,830	589	8,377	4,297	1,662	438
Germany	11,084	1,518	109	99	12,810	1,083	416	10,648	1,291	386	219
Netherlands	2,749	1,357	6,163	201	10,470	6,892	(8)	3,469	984	6,238	264
Spain	81	5,131	1,632	8	6,852	6,724	(1,408)	88	5,264	1,657	9
France	4,605	988	561	247	6,401	639	52	5,912	774	630	71
Japan	3,575	-	-	6	3,581	-	1	4,354	-	80	2
Australia	-	1,834	262	289	2,385	495	(17)	-	1,659	320	93
MDBs (1)	-	-	1,112	-	1,112	-	37	-	-	912	-
Italy	852	168	55	6	1,081	221	(215)	906	198	54	15
Singapore	732	180	20	-	932	-	-	649	189	20	-
Belgium	771	39	-	3	813	34	(91)	763	39	-	1
India	627	176	-	-	803	-	(6)	548	139	-	-
Hong Kong	641	-	-	-	641	-	-	905	8	-	-
Denmark	433	183	-	-	616	-	-	629	172	-	-
Austria	296	61	105	140	602	156	(40)	274	67	4	131
Sweden	39	379	141	26	585	250	1	30	288	131	15
Switzerland	323	228	-	7	558	-	1	657	148	-	8
Greece	532	-	-	-	532	-	-	895	-	-	-
Republic of Ireland	115	176	1	91	383	151	(83)	104	435	62	88
South Korea	138	-	86	-	224	86	-	261	-	429	-
< £0.5bn	1,383	403	510	151	2,447	623	(142)	1,773	326	590	95
	62,336	17,268	28,463	2,334	110,401	41,091	(390)	63,486	16,982	29,148	1,514
Tax on AFS reserves							11				
AFS reserves net of tax							(379)				

(1) Represents multilateral development banks and other supranational organisations.

Risk and balance sheet management (continued)

Risk management: Credit risk: Derivatives

The Group's derivative assets by internal grading scale and residual maturity are analysed below. Master netting arrangements in respect of mark-to-market (mtm) positions and collateral shown below do not result in a net presentation in the Group's balance sheet under IFRS.

		30 September 2011						30 June	31 December
		0-3	3-6	6-12	1-5	Over 5		2011	2010
Asset	Probability	months	months	months	years	years	Total	Total	Total
quality	of default range	£m	£m	£m	£m	£m	£m	£m	£m
AQ1	0% - 0.034%	41,121	13,820	19,858	137,585	304,713	517,097	357,031	408,489
AQ2	0.034% - 0.048%	591	116	347	2,016	4,195	7,265	5,600	2,659
AQ3	0.048% - 0.095%	2,618	525	939	3,609	6,832	14,523	10,908	3,317
AQ4	0.095% - 0.381%	1,135	399	828	3,373	4,670	10,405	6,624	3,391
AQ5	0.381% - 1.076%	4,469	173	341	2,707	6,019	13,709	6,933	4,860
AQ6	1.076% - 2.153%	282	65	78	929	1,117	2,471	3,595	1,070
AQ7	2.153% - 6.089%	327	134	93	670	2,144	3,368	2,072	857
AQ8	6.089% - 17.222%	3	11	30	160	970	1,174	654	403
AQ9	17.222% - 100%	10	12	19	402	697	1,140	486	450
AQ10	100%	26	11	48	713	394	1,192	969	1,581
		50,582	15,266	22,581	152,164	331,751	572,344	394,872	427,077
Counterparty mtm netting							(473,256)	(323,455)	(330,397)
Cash collateral held against derivative exposures							(38,202)	(27,500)	(31,096)
Net exposure							60,886	43,917	65,584

At 30 September 2011, the Group also held collateral in the form of securities of £5.5 billion (30 June 2011 - £4.2 billion; 31 December 2010 - £2.9 billion) against derivative positions.

The table below analyses the fair value of the Group's derivatives by type of contract.

	30 September 2011		30 June 2011		31 December 2010	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Contract type	£m	£m	£m	£m	£m	£m
Interest rate contracts	424,130	407,814	283,966	269,638	311,731	299,209
Exchange rate contracts	107,024	112,184	72,682	78,095	83,253	89,375
Credit derivatives	33,884	31,574	32,507	30,877	26,872	25,344

Equity and commodity contracts	7,306	10,218	5,717	9,199	5,221	10,039
	572,344	561,790	394,872	387,809	427,077	423,967

Key points

30 September 2011 compared with 30 June 2011

· Net exposure, after taking account of position and collateral netting arrangements, increased significantly (up 39%) due to higher derivative fair values (see below) primarily reflecting economic uncertainty and the eurozone crisis.

· Continued reductions in interest rates and the depreciation of sterling against the US dollar resulted in an increase in fair values of interest rate contracts. This was partially offset by the effect of the appreciation of sterling against the euro. All major five and ten year interest rate indices (sterling, euro, and the US dollar), moved down, decreasing by approximately 74 to 84 and 90 to 116 basis points respectively.

Risk and balance sheet management (continued)

Risk management: Credit risk: Derivatives (continued)

Key points (continued)

30 September 2011 compared with 30 June 2011 (continued)

· Exchange rate contracts increased due to increased volume, trading fluctuations and the depreciation of sterling against the US dollar, as the majority of exchange rate contracts are US dollar denominated.

· Credit derivative fair values increased due to widening credit spreads.

30 September 2011 compared with 31 December 2010

· Net exposure, after taking account of position and collateral netting arrangements, reduced by 7%, despite an increase in derivative carrying values primarily due to increased use of netting arrangements.

· Interest rate contracts increased due to continued reductions in interest rate yields. This was partially offset by the effect of marginal appreciation of sterling against the US dollar and the euro.

· Exchange rate contracts increased due to trading fluctuations and movements in forward rates and volume.

· Credit derivative fair values increased due to widening credit spreads.

Risk and balance sheet management (continued)

Risk management: Credit risk: Derivatives (continued)

The Group's exposures to monolines and CDPCs by credit rating are summarised below, ratings are based on the lower of S&P and Moody's. All of these exposures are held within Non-Core.

Exposures to monoline insurers

	Notional: protected assets £m	Fair value: reference protected assets £m	Gross exposure £m	Credit valuation adjustment (CVA) £m	Hedges £m	Net exposure £m
30 September 2011						
A to AA-	5,411	4,735	676	259	-	417
Non-investment grade	7,098	3,684	3,414	2,568	70	776
	12,509	8,419	4,090	2,827	70	1,193
Of which:						
CMBS	3,954	1,879	2,075	1,599		
CDOs	988	156	832	619		
CLOs	4,806	4,348	458	183		
Other ABS	2,275	1,758	517	309		
Other	486	278	208	117		
	12,509	8,419	4,090	2,827		
30 June 2011						
A to AA-	5,547	4,936	611	166	-	445
Non-investment grade	7,079	4,047	3,032	2,155	68	809
	12,626	8,983	3,643	2,321	68	1,254
Of which:						
CMBS	3,853	2,131	1,722	1,285		
CDOs	1,086	230	856	596		
CLOs	4,946	4,561	385	107		
Other ABS	2,241	1,739	502	250		
Other	500	322	178	83		
	12,626	8,983	3,643	2,321		
31 December 2010						
A to AA-	6,336	5,503	833	272	-	561
Non-investment grade	8,555	5,365	3,190	2,171	71	948
	14,891	10,868	4,023	2,443	71	1,509

Of which:				
CMBS	4,149	2,424	1,725	1,253
CDOs	1,133	256	877	593
CLOs	6,724	6,121	603	210
Other ABS	2,393	1,779	614	294
Other	492	288	204	93
	14,891	10,868	4,023	2,443

Risk and balance sheet management (continued)

Risk management: Credit risk: Derivatives (continued)

Exposure to monoline insurers (continued)

Key points

30 September 2011 compared with 30 June 2011

· The gross exposure, principally to monolines, increased reflecting the effect of credit spread on the underlying reference instruments and strengthening of the US dollar against sterling.

· The increased CVA reflected the increase in exposure and the widened credit spreads of monoline insurers.

30 September 2011 compared with 31 December 2010

· The increase in monoline CVA on a year-to-date basis was primarily attributable to wider monoline credit spreads.

Exposure to CPDCs

	Notional: protected assets £m	Fair value: reference protected assets £m	Gross exposure £m	Credit valuation adjustment £m	Net exposure £m
30 September 2011					
AAA	211	209	2	-	2
A to AA-	640	614	26	15	11
Non-investment grade	19,294	17,507	1,787	902	885
Unrated	3,985	3,552	433	316	117
	24,130	21,882	2,248	1,233	1,015
30 June 2011					
AAA	205	205	-	-	-
A to AA-	622	607	15	4	11
Non-investment grade	19,724	18,759	965	427	538
Unrated	3,927	3,712	215	101	114

	24,478	23,283	1,195	532	663
31 December 2010					
AAA	213	212	1	-	1
A to AA-	644	629	15	4	11
Non-investment grade	20,066	19,050	1,016	401	615
Unrated	4,165	3,953	212	85	127
	25,088	23,844	1,244	490	754

Risk and balance sheet management (continued)

Risk management: Credit risk: Derivatives (continued)

Exposure to CPDCs (continued)

Key points

30 September 2011 compared with 30 June 2011

· The increase in gross exposure to CDPCs was mainly driven by wider credit spreads of the underlying reference loans and bonds coupled with the increase in the relative value of senior tranches.

· CVA as a percentage of gross exposures increased from 45% to 55% principally reflecting higher CVA on certain CDPCs due to increased risks in the portfolio.

30 September 2011 compared with 31 December 2010

· The year-to-date increase in the gross exposure to CDPCs mainly in Q3 2011, resulted from wider credit spreads of the underlying reference loans and bonds coupled with the increase in the relative value of senior tranches.

· CVA as a percentage of gross exposures increased from 39% to 55%, as noted above.

Risk and balance sheet management (continued)

Risk management: Credit risk: Country risk

Background
All country exposures are covered by the Group's country risk framework. This framework includes active management of portfolios either when these have been identified as exhibiting signs of stress, using the Group's country risk watch list process, or when it is otherwise considered appropriate. Granular portfolio reviews are undertaken to align country risk profiles to the Group's country risk appetite in light of evolving economic and political developments. Accordingly, limit controls are tailored to the level of risk associated with each country.

Ongoing concern surrounding the most vulnerable eurozone economies has intensified the Group's vigilance and controls. This involves frequent, comprehensive and detailed reviews of exposures to each of these countries, including increased prudence in counterparty monitoring which has led to several divestments and exposure reductions. In addition to Greece, Portugal and Ireland, the Group has recently brought Italy and Spain under tighter controls, and country limits are being set in response to these countries' uncertain outlook.

Country events in North Africa and the Middle East, a tsunami plus nuclear disaster in Japan, and developments in the eurozone have placed crisis management on the daily agenda for country risk this year. Following on from sovereign related stress tests and a series of broad thematic reviews, a Group wide response plan has been prepared to position the Group against potential increased stress in the eurozone. The plan covers themes such as sovereign debt restructuring, various eurozone breakup scenarios and a re-examination of prospective financial sector support given ongoing public finance and political pressures.

The following tables show the Group's exposure to countries at 30 September 2011, where the on-balance sheet exposure to counterparties incorporated in the country exceeded £1 billion and where the country had an external rating of A+ or below from S&P, Moody's or Fitch, as well as selected other eurozone countries. The numbers are stated before taking into account the impact of mitigating action, such as collateral, insurance or guarantees that may have been taken to reduce or eliminate exposure to country risk events. Shipping related exposures are not included due to their multinational nature.

The following apply to the tables on pages 128 to 140:

Lending comprises loans and advances, gross of impairment provisions, to: central banks, including cash balances; other banks and financial institutions, incorporating overdraft and other short-term facilities; corporations, in large part loans and leases; and individuals, comprising mortgages, personal loans and credit card balances. Risk elements in lending (REIL) are included within lending and comprise impaired loans and loans where an impairment event has taken place.

Risk management: Credit risk: Country risk (continued)

Background (continued)

Debt securities comprise securities classified as available-for-sale (AFS), loans and receivables (LAR), held-for-trading (HFT) and designated as at fair value through profit or loss (DFV). All debt securities other than LAR securities are carried at fair value; LAR debt securities are carried at amortised cost less impairment. HFT debt securities are presented net of short positions per country. Impairment losses and exchange differences relating to AFS debt securities, together with interest are recognised in the income statement; other changes in the fair value of AFS securities are reported within AFS reserves.

Derivatives comprise the marked-to-market (mtm) value of such contracts after the effect of enforceable netting agreements, but gross of collateral. Repos comprise the marked-to-market value of counterparty exposure arising from repo transactions net of collateral.

Off balance sheet amounts comprise the sum of contingent liabilities, including guarantees, and committed undrawn facilities.

Credit default swaps (CDS): Under a CDS contract the buyer is protected in the event of the default of the reference entity by the seller. Fair value or mtm value of CDS represents the carrying value on the balance sheet. The mtm value

of CDSs is included within derivatives against the counterparty of the credit derivative, as opposed to the reference entity.

Risk and balance sheet management (continued)

Risk management: Credit risk: Country risk (continued)

Summary

				Lending				Of which			Derivatives
30 September 2011	Central and local government	Central banks	Other banks	Other financial institutions	Corporate	Personal	Total lending	Core	Non-Core	Debt securities	Derivatives (gross of collateral) and repos
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Eurozone:											
Ireland	54	2,235	49	542	19,574	19,606	42,060	31,549	10,511	900	2,354
Spain	10	3	554	90	6,599	380	7,636	3,505	4,131	6,497	2,521
Italy	-	76	420	472	2,057	25	3,050	1,437	1,613	1,180	2,331
Greece	7	10	1	32	381	14	445	325	120	707	335
Portugal	43	-	57	-	579	5	684	333	351	139	443
Other											
- Germany	-	15,483	1,473	334	7,099	166	24,555	18,832	5,723	17,434	15,769
- Netherlands	2,257	7,393	642	1,896	5,540	21	17,749	15,003	2,746	11,729	11,290
- France	503	56	1,998	695	4,354	79	7,685	5,218	2,467	11,125	9,777
- Luxembourg	-	27	92	1,087	2,448	3	3,657	2,060	1,597	162	3,663
- Belgium	226	13	384	399	800	20	1,842	1,273	569	920	2,818
Rest of eurozone	120	-	61	115	1,511	26	1,833	1,494	339	1,152	1,919
Other selected countries											
India	-	164	1,382	94	3,295	150	5,085	4,670	415	1,867	194
China	23	170	2,226	6	746	55	3,226	3,033	193	444	762
South Korea	-	39	1,024	3	636	1	1,703	1,693	10	1,106	589
Turkey	231	27	294	55	1,187	15	1,809	1,330	479	386	83
Russia	-	20	986	44	852	69	1,971	1,851	120	107	93
Brazil	-	-	1,035	-	273	4	1,312	1,201	111	659	25
Romania	30	174	22	15	473	410	1,124	13	1,111	302	10
Mexico	-	-	207	-	993	1	1,201	819	382	27	127
Indonesia	77	31	288	23	311	110	840	720	120	139	365
Poland	37	-	-	10	635	5	687	639	48	294	60

For definitions refer to pages 126 and 127.

Risk and balance sheet management (continued)

Risk management: Credit risk: Country risk (continued)

Summary(continued)

	Lending										
								Of which			Derivatives
31 December 2010	Central and local government	Central banks	Other banks	Other financial institutions	Corporate	Personal	Total lending	Core	Non-Core	Debt securities	(gross of collateral) and repos
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Eurozone:											
Ireland	61	2,119	87	813	19,881	20,228	43,189	32,432	10,757	1,323	2,940
Spain	19	5	166	92	6,962	407	7,651	3,130	4,521	7,107	2,047
Italy	45	78	668	418	2,483	27	3,719	1,818	1,901	3,836	2,030
Greece	14	36	18	31	188	16	303	173	130	974	203
Portugal	86	-	63	-	611	6	766	450	316	242	393
Other											
- Germany	-	10,894	1,060	422	7,423	162	19,961	13,586	6,375	14,747	15,263
- Netherlands	914	6,484	554	1,801	6,161	81	15,995	12,792	3,203	12,523	9,035
- France	511	3	1,095	470	4,376	102	6,557	3,769	2,788	14,041	8,606
- Luxembourg	-	25	26	734	2,503	3	3,291	1,773	1,518	378	2,545
- Belgium	102	14	441	32	893	327	1,809	1,307	502	803	2,207
Rest of eurozone	124	1	142	119	1,503	24	1,913	1,581	332	535	1,351
Other selected countries											
India	-	-	1,307	307	2,590	273	4,477	3,824	653	1,686	177
China	17	298	1,223	16	753	64	2,371	2,135	236	573	251
South Korea	-	276	1,033	5	555	2	1,871	1,821	50	1,353	457
Turkey	282	68	448	37	1,365	12	2,212	1,520	692	550	103
Russia	-	110	244	7	1,181	58	1,600	1,475	125	124	51
Brazil	-	-	825	-	315	5	1,145	1,025	120	687	15
Romania	36	178	21	21	426	446	1,128	7	1,121	310	8
Mexico	-	8	149	-	999	1	1,157	854	303	144	122
Indonesia	84	42	242	19	294	131	812	658	154	356	249
Poland	-	168	7	7	655	6	843	735	108	271	69

For definitions refer to pages 126 and 127.

Risk management: Credit risk: Country risk (continued)

External risk environment

So far 2011 has seen heightened country risks, which have intensified in the past quarter. However, trends have been divergent. Conditions have deteriorated among vulnerable eurozone countries facing growth impediments and higher public debt burdens, with market risks rising sharply in the past quarter. Many emerging markets have continued to enjoy relative stability, seeing net inflows of capital and lower spreads despite the impact of higher risk aversion in Q3 2011. In the US, notwithstanding a sovereign downgrade from a rating agency, a deal was secured to increase the sovereign debt ceiling, and yields on government debt remain low.

Europe has been at the centre of rising global risks, owing to a combination of slower growth among some of its major economies and a further deepening of the ongoing sovereign crisis which has in turn, increasingly harmed financial sector health. Risks in Greece have risen as a deeper than expected contraction in GDP has adversely affected the fiscal adjustment programme and hit debt sustainability. Some private sector creditors have proposed a burden sharing agreement to reduce debt repayments somewhat, but market prices of sovereign debt have implied investor expectations of a broader debt restructuring and concerns over contagion have risen sharply.

Despite the announcement of significant new support proposals by eurozone leaders in July, investor worries over risks to their implementation rose and market conditions worsened markedly through Q3 2011 as a result. Risk aversion towards Spanish and Italian assets picked up and despite a policy response by both countries, yields remained elevated, prompting the European Central Bank (ECB) to intervene to support their bonds in secondary markets for the first time. Contagion affected bank stocks and asset prices. At the International Monetary Fund (IMF) annual meetings in September, eurozone leaders agreed to enhance anti-crisis measures. Some steps, including boosting the resources of the European Financial Stability Facility and a proposed 50% voluntary haircut by private sector investors holding Greek debt, were taken at two key summits in October, but implementation risks remain high. Within a week of the summit, Greece proposed a referendum on its commitments under the deal, resulting in renewed concerns over the possibility of a more comprehensive restructuring.

Meanwhile, Portugal's new government has continued to remain on track with implementation of the European Union - International Monetary Fund (EU-IMF) deal agreed in May after a sharp deterioration in sovereign liquidity. Ireland's performance under its EU-IMF programme has been good and the announcement of a bank restructuring deal without defaults on senior debt obligations has helped improve market confidence. This was reflected in a compression in bond spreads in Q3 2011.

Emerging markets have meanwhile continued to perform relatively well. In Asia, despite growth slowing, China and India have continued to post strong overall expansion, while generally large external savings levels have reinforced balance of payments stability. In China specifically, measures to curb house price growth have proven effective, though concerns over bank asset quality linked to rapid lending growth in 2009 have risen.

In Emerging Europe, Russia has seen some contagion into asset markets from weaker commodity prospects and a challenging investment climate, but the sovereign balance sheet remains quite robust. Foreign exchange exposures remain a risk factor in a number of Eastern European economies. Elsewhere, Turkey's economy cooled in Q3 2011, helping to narrow the current account deficit sharply, though external vulnerabilities remain.

Risk and balance sheet management (continued)

Risk management: Credit risk: Country risk (continued)

External risk environment (continued)

The Middle East and North Africa has been characterised by political instability in a number of the relatively lower income countries. Excluding Bahrain, pressures for change have been more contained in the Gulf Cooperation Council countries.

Latin America continues to be characterised by relative stability owing to balance sheet repair by a number of countries following crises in previous decades. Capital inflows have contributed to currency appreciation, but overheating pressures have so far proven contained, including in Brazil where credit growth has slowed from high levels.

Overall, the outlook for the rest of the year remains challenging, with risks likely to remain elevated but divergent. Much will depend on the success of EU efforts to contain contagion from the sovereign crisis and whether growth headwinds in larger advanced economies persist. Emerging market balance sheet risks remain lower, despite ongoing structural and political constraints, but these economies will continue to be affected by events elsewhere through financial markets and trade channels.

Key points

· Currency movements had a significant impact on exposures in the third quarter as sterling fell by 2.8% against the US dollar and rose by 5.0% against the euro. However, they had less impact on exposures year-to-date as sterling rose by only 0.6% against the US dollar and 0.2% against the euro over the first three quarters of 2011.
· Total exposure to over half of the countries shown in the table decreased over the nine months since 31 December 2010, driven partly by clients' debt reduction efforts and partly by a restrictive stance on the part of the Group. Reductions were seen particularly in off-balance sheet exposures and in lending. Exposures generally increased in (collateralised) derivatives and repos.
· India - Continued strong economic growth led total exposure to grow by £1.1 billion so far this year, largely due to increases in lending to corporate clients (£0.7 billion) and in debt securities (£0.2 billion).
· China - Lending to Chinese banks increased by £1.0 billion to £2.4 billion in 2011. This reflects increased activity with the top tier banks, partially driven by on-shore regulatory needs, and an increase in trade finance activity. These credit facilities support trade within the Asia-Pacific region as well as a number of key UK clients with trade finance requirements in China.
· South Korea - Total exposure deceased by £0.6 billion, largely due to reductions in debt securities reflecting a hedge against a derivatives position which decreased over the course of the year and a reduction in off-balance exposures reflecting the expiration of a large medium-term guarantee and the Group's cautious stance given the current global economic downturn.
· Eurozone - Portfolio composition and trends in a number of vulnerable eurozone countries are discussed in more detail below. Here, most peripheral eurozone exposure decreased, with derivatives and repos being the only component that still saw some gross increases in the third quarter. The CDS positions referencing sovereign debt are generally collateralised and are with large international banks or large international asset management companies outside the country of the referenced sovereign.
· In the rest of the eurozone, exposure in the first nine months of 2011 increased mainly in lending to central banks (in Germany and the Netherlands, largely deposits of excess liquidity), to governments (the Netherlands) and to banks, particularly in the first half of the year (France and the Netherlands), as well as in derivatives and repos (the Netherlands, France and Luxembourg).

Risk management: Credit risk: Country risk: Ireland

Issuer	Lending £m	REIL £m	Impairment provisions £m	AFS and LAR debt securities £m	AFS reserves £m	HFT debt securities Long £m	HFT debt securities Short £m	Total debt securities £m	Derivatives (gross of collateral) and repos £m	Contingent liabilities and commitments £m
30 September 2011										
Central and local government	54	-	-	115	(40)	30	30	115	20	1
Central banks	2,235	-	-	-	-	-	-	-	1	-
Other banks	49	-	-	176	(44)	67	-	243	901	52
Other financial institutions	542	-	-	57	-	250	52	255	1,024	691
Corporate	19,574	10,195	5,667	148	1	139	-	287	407	2,061
Personal	19,606	2,210	954	-	-	-	-	-	1	535
	42,060	12,405	6,621	496	(83)	486	82	900	2,354	3,340
31 December 2010										
Central and local government	61	-	-	104	(45)	93	88	109	20	1
Central banks	2,119	-	-	-	-	7	-	7	126	-
Other banks	87	-	-	435	(51)	96	45	486	1,523	83
Other financial institutions	813	-	-	291	(1)	205	-	496	837	1,050
Corporate	19,881	8,291	4,072	91	(2)	140	6	225	434	2,633
Personal	20,228	1,638	534	-	-	-	-	-	-	544
	43,189	9,929	4,606	921	(99)	541	139	1,323	2,940	4,311

Fair values of CDS referencing sovereign exposures were:

Fair value	30 September 2011 £m	31 December 2010 £m

Bought protection	511	360
Sold protection	523	387

For definitions refer to pages 126 and 127.

Risk and balance sheet management (continued)

Risk management: Credit risk: Country risk: Ireland (continued)

Key points

The Group has significant exposure to Ireland, largely through Ulster Bank. The portfolio is predominantly personal lending of £19.6 billion (largely mortgages) and corporate lending of £19.6 billion. In addition, the Group has lending and derivatives exposure to the Central Bank of Ireland, financial institutions and large international clients with funding units based in Ireland.

Total Group exposure (including off-balance sheet) declined by £3.1 billion to less than £50 billion from December 2010 to September 2011. Ulster Bank currently represents 87% of the Group's total Irish exposure.

Central and local government and central bank

Exposure to the government is modest at £0.2 billion.

Exposure to the central bank fluctuates, driven by reserve requirements and by placings of excess liquidity as part of the Group's assets and liabilities management. At 30 September 2011, exposure was £2.2 billion.

Financial institutions

Interbank lending, which is provided to the largest, systemically important Irish banks, is approximately £50 million.

Derivatives and repos exposure in GBM to banks and other financial institutions increased by £0.8 billion over the year to date. Transactions are typically collateralised.

Corporations

Corporate lending exposure decreased by approximately £0.3 billion in the nine months ended 30 September 2011. Exposure in this area is highest in the property sector £12.5 billion, which also experienced the biggest reduction, £160 million, in the same period. Risk elements in lending of £10.2 billion and impairment provisions of £5.7 billion, up since December 2010 by £1.9 billion and £1.6 billion respectively, are further discussed in the Ulster Bank section.

Personal

The Ulster Bank retail portfolio mainly consists of mortgages (approximately 92%), with the remainder comprising other personal lending and credit card exposure (see also page 142).

Non-Core

Of the total Irish exposure, £11.5 billion is designated Non-Core, £10.0 billion of which is related to commercial real estate.

Risk and balance sheet management (continued)

Risk management: Credit risk: Country risk: Spain

Issuer	Lending £m	REIL £m	Impairment provisions £m	AFS and LAR debt securities £m	AFS reserves £m	HFT debt securities Long £m	HFT debt securities Short £m	Total debt securities £m	Derivatives (gross of collateral) and repos £m	Contingent liabilities and commitments £m
30 September 2011										
Central and local government	10	-	-	81	(9)	864	1,271	(326)	40	30
Central banks	3	-	-	-	-	-	-	-	-	-
Other banks	554	-	-	5,131	(820)	137	178	5,090	1,904	40
Other financial institutions	90	-	-	1,694	(579)	71	55	1,710	32	228
Corporate	6,599	1,438	690	8	-	18	3	23	545	1,635
Personal	380	1	-	-	-	-	-	-	-	57
	7,636	1,439	690	6,914	(1,408)	1,090	1,507	6,497	2,521	1,990
31 December 2010										
Central and local government	19	-	-	88	(7)	1,172	1,248	12	53	1
Central banks	5	-	-	-	-	-	-	-	-	-
Other banks	166	-	-	5,264	(834)	147	118	5,293	1,482	41
Other financial institutions	92	-	-	1,724	(474)	34	7	1,751	22	285
Corporate	6,962	1,871	572	9	38	50	8	51	490	2,494
Personal	407	1	-	-	-	-	-	-	-	62
	7,651	1,872	572	7,085	(1,277)	1,403	1,381	7,107	2,047	2,883

Fair values of CDS referencing sovereign exposures were:

Fair value	30 September 2011 £m	31 December 2010 £m
Bought protection	562	436
Sold protection	547	435

For definitions refer to pages 126 and 127.

Risk and balance sheet management (continued)

Risk management: Credit risk: Country risk: Spain (continued)

Key points

The Group's exposure to Spain consists primarily of lending to major investment grade corporations and a large covered bond portfolio.

Total (on and off-balance sheet) exposure decreased by £1.0 billion in the nine months ended 30 September 2011 to £18.6 billion, the majority of which consists of exposure to the property, natural resource and banking sectors.

Central and local government and central bank

The Group's exposure to the government is negative owing to a net short position in held-for-trading debt securities.

Financial institutions

A sizeable covered bond portfolio of £6.8 billion is the Group's largest exposure to Spanish banks and other financial institutions. Stress analysis on the AFS debt securities indicates that this exposure is unlikely to suffer material credit losses.

A further £1.9 billion of the Group's exposure to financial institutions consists of fully collateralised derivatives exposure to the top banks and a few of the largest regional banks. Lending to banks of almost £0.6 billion consists mainly of short-term money market lines with the top two international Spanish banks.

Corporations

Total exposure to corporate clients declined by £1.2 billion in the nine months ended 30 September 2011, driven by reductions in exposure to corporations in the property and telecom, media and technology sectors. REIL relates to commercial real estate lending and decreased reflecting disposals and restructurings; however provision increased due to declining collateral values.

Non-Core

Of the total Spanish exposure, £4.9 billion is in Non-Core, the majority of which is related to either real estate or project finance. Current Spanish property market conditions present significant disposal challenges. Despite this, Non-Core continues to seek divestment opportunities across the portfolio.

Risk and balance sheet management (continued)

Risk management: Credit risk: Country risk: Italy

Issuer	Lending £m	REIL £m	Impairment provisions £m	AFS and LAR debt securities £m	AFS reserves £m	HFT debt securities Long £m	HFT debt securities Short £m	Total debt securities £m	Derivatives (gross of collateral) and repos £m	Contingent liabilities and commitments £m
30 September 2011										
Central and local government	-	-	-	852	(191)	5,076	5,634	294	103	-
Central banks	76	-	-	-	-	-	-	-	-	-
Other banks	420	-	-	168	(16)	88	5	251	1,143	26
Other financial institutions	472	-	-	538	(8)	49	81	506	672	957
Corporate	2,057	451	139	68	-	61	-	129	413	2,172
Personal	25	-	-	-	-	-	-	-	-	13
	3,050	451	139	1,626	(215)	5,274	5,720	1,180	2,331	3,168
31 December 2010										
Central and local government	45	-	-	906	(99)	5,113	3,175	2,844	71	6
Central banks	78	-	-	-	-	-	-	-	-	-
Other banks	668	-	-	198	(11)	67	16	249	782	161
Other financial institutions	418	-	-	646	(5)	49	-	695	759	1,217
Corporate	2,483	314	141	20	-	36	8	48	418	2,456
Personal	27	-	-	-	-	-	-	-	-	13
	3,719	314	141	1,770	(115)	5,265	3,199	3,836	2,030	3,853

Fair values of CDS referencing sovereign exposures were:

Fair value	30 September 2011 £m	31 December 2010 £m
Bought protection	1,815	641
Sold protection	1,691	551

For definitions refer to pages 126 and 127.

Risk and balance sheet management (continued)

Risk management: Credit risk: Country risk: Italy (continued)

Key points

The Group is an active market maker in Italian government bonds, resulting in substantial long positions in held-for-trading securities against approximately equal short positions.

The Group maintains relationships with government entities, banks, other financial institutions and large corporate clients, in the case of the latter predominantly with subsidiaries of multinationals. Since the start of 2011 the Group has taken steps to reduce and mitigate its risks through increased collateral requirements, additional security and strategic exits where appropriate, in line with its evolving appetite for Italian risk. Total exposure to entities incorporated in Italy declined by £3.7 billion in the nine months ended 30 September 2011, to £9.7 billion, much of which was lending to corporate clients, banks and other financial institutions.

Central and local government and central bank

Total exposure to the government including net debt securities positions was significantly reduced by £2.6 billion to £0.4 billion.

Financial institutions

The majority of the Group's exposure to Italian financial institutions is concentrated on the two largest, systemically important groups and consists of collateralised derivatives and, to a lesser extent, short-term interbank lending.

Corporations

Since 31 December 2010, total exposure has declined by approximately £0.6 billion, driven in part by reductions in lending to the property industry. However, the Group has maintained lending facilities to the manufacturing and natural resource sectors.

Non-Core

Of the total Italian exposure, £1.8 billion is in Non-Core, the majority of which is related to real estate or project finance. The key risk in the portfolio is the availability of refinancing options for current clients.

Risk and balance sheet management (continued)

Risk management: Credit risk: Country risk: Greece

Issuer	Lending £m	REIL £m	Impairment provisions £m	AFS and LAR debt securities £m	AFS reserves £m	HFT debt securities Long £m	HFT debt securities Short £m	Total debt securities £m	Derivatives (gross of collateral) and repos £m	Contingent liabilities and commitments £m
30 September 2011										
Central and local government	7	-	-	532	-	180	7	705	-	-
Central banks	10	-	-	-	-	-	-	-	-	-
Other banks	1	-	-	-	-	-	-	-	299	1
Other financial institutions	32	-	-	-	-	-	-	-	2	-
Corporate	381	335	249	-	-	2	-	2	34	60
Personal	14	-	-	-	-	-	-	-	-	10
	445	335	249	532	-	182	7	707	335	71
31 December 2010										
Central and local government	14	-	-	895	(694)	118	39	974	7	7
Central banks	36	-	-	-	-	-	-	-	-	-
Other banks	18	-	-	-	-	-	-	-	167	1
Other financial institutions	31	-	-	-	-	-	-	-	3	3
Corporate	188	48	48	-	-	-	-	-	26	141
Personal	16	-	-	-	-	-	-	-	-	10
	303	48	48	895	(694)	118	39	974	203	162

Fair values of CDS referencing sovereign exposures were:

	30 September 2011	31 December 2010

Fair value	£m	£m
Bought protection	1,832	854
Sold protection	1,720	871

For definitions refer to pages 126 and 127.

Risk and balance sheet management (continued)

Risk management: Credit risk: Country risk: Greece (continued)

Key points

Given the continued economic distress in Greece, the Group is actively managing its exposure to this country.

Much of the exposure is collateralised or guaranteed. As a result, the Group has reduced its effective exposure to Greece in line with the de-risking strategy that has been in place since early 2010.

Central and local government and central bank

As a result of the continued deterioration in Greece's fiscal position, coupled with the potential for the restructuring of Greek sovereign debt, the Group recognised an impairment charge in respect of available-for-sale Greek government bonds in H1 2011. These bonds continue to represent a significant proportion of the total Greek portfolio.

Financial institutions

Exposure to Greek banks remains under close scrutiny and is actively managed. Lending exposures to banks are very small.

The gross derivatives exposure to banks increased by slightly over £0.1 billion in the third quarter but is largely collateralised; the remainder consists for the most part of transactions conducted with Greek subsidiaries of non-Greek banks.

Corporations

At the start of the year, a number of defaulted clients re-incorporated in Greece causing a £0.2 billion increase in lending as well as increases in the risk elements in lending and in impairment provisions.

The ongoing deterioration in Greek sovereign credit quality led to some further increase in provisions and to a rigorous review of Greek corporate exposure.

Accordingly, and allowing for the effect described above, the Group's total corporate exposure is declining. The focus is now on short-term trade facilities to the domestic subsidiaries of international clients, increasingly supported by parental guarantees.

Non-Core

Of the total Greek exposure, £0.2 billion is in Non-Core.

Risk and balance sheet management (continued)

Risk management: Credit risk: Country risk: Portugal

Issuer	Lending £m	REIL £m	Impairment provisions £m	AFS and LAR debt securities £m	AFS reserves £m	HFT debt securities Long £m	HFT debt securities Short £m	Total debt securities £m	Derivatives (gross of collateral) and repos £m	Contingent liabilities and commitments £m
30 September 2011										
Central and local government	43	-	-	66	(53)	70	152	(16)	19	-
Central banks	-	-	-	-	-	-	-	-	-	-
Other banks	57	-	-	91	(37)	14	11	94	338	-
Other financial institutions	-	-	-	5	-	13	-	18	12	-
Corporate	579	27	27	43	-	-	-	43	74	348
Personal	5	-	-	-	-	-	-	-	-	8
	684	27	27	205	(90)	97	163	139	443	356
31 December 2010										
Central and local government	86	-	-	92	(26)	68	122	38	29	211
Central banks	-	-	-	-	-	-	-	-	-	-
Other banks	63	-	-	106	(24)	46	2	150	307	2
Other financial institutions	-	-	-	47	-	7	-	54	7	1
Corporate	611	27	21	-	1	-	-	-	50	512
Personal	6	-	-	-	-	-	-	-	-	8
	766	27	21	245	(49)	121	124	242	393	734

Fair values of CDS referencing sovereign exposures were:

Fair value	30 September 2011 £m	31 December 2010 £m
Bought protection	1,053	471
Sold protection	1,041	460

For definitions refer to pages 126 and 127.

Risk and balance sheet management (continued)

Risk management: Credit risk: Country risk: Portugal (continued)

Key points

Following the closure of its local branch in early 2011, the Group has modest exposure overall. The portfolio is focused on corporate lending and derivatives trading with the largest local banks.

Central and local government and central bank

In the first nine months of 2011, the sovereign risk position was reduced, largely the result of decreases in contingent exposures to three public sector entities in addition to bond sales and maturities. Overall, the exposure shrank to less than £50 million in the nine months.

Financial institutions

As the Portuguese economy deteriorated, the Group reduced its exposure in all areas.

Approximately 90% of remaining counterparty exposures are focused on the top four systemically important financial groups. Exposures generally consist of collateralised trading products and short-term treasury lines.

Corporations

The Group's exposure is concentrated on large highly creditworthy clients. The largest exposure is to corporations active in the energy and transport sectors.

Trade finance exposure was nearly halved in the third quarter to £50 million.

Non-Core

Of the total Portuguese exposure, £0.6 billion is in Non-Core, 87% of which is related to project finance.

Risk and balance sheet management (continued)

Risk management: Credit risk: Ulster Bank Group (Core and Non-Core)

Overview

Ulster Bank Group accounts for 9.8% of the Group's total gross customer loans (30 June 2011 - 10.2%; 31 December 2010 - 9.9%) and 8.5% of the Group's Core gross customer loans (30 June 2011 - 8.8%; 31 December 2010 - 8.9%). The Q3 2011 impairment charge was £608 million (Q3 2010 - £962 million) with commercial real estate and mortgage sectors accounting for £314 million (52%) and £126 million (21%) of the total Q3 2011 impairment charge respectively. The impairment charge in Q3 2011 was driven by a combination of new defaulting customers and deteriorating security values. Provisions as a percentage of REIL has increased from 51.4% at 30 June 2011 to 51.6% at 30 September 2011 (30 September 2010 - 39%).

The impairment charge of £608 million for Q3 2011 was £638 million lower than the £1,246 million impairment charge for Q2 2011. Non-Core was the main driver for this reduction with its impairment charge £696 million lower in Q3 2011 compared with Q2 2011 due to a slower rate of deterioration in security values and a decrease in the value of loans defaulting in the quarter. The Core portfolio quarterly impairment charge increased by £58 million to £327 million (Q2 2011- £269 million), with the mortgage portfolio accounting for £48 million of the increase. Impairments remain elevated as high unemployment coupled with higher taxation and less liquidity in the economy continues to depress the property market and domestic spending.

Core

The Q3 2011 impairment charge was £327 million (Q3 2010 - £286 million) with the mortgage sector accounting for £126 million (39%) of the total Q3 2011 impairment charge. These impairment losses reflect the difficult economic climate in Ireland with elevated default levels across both mortgage and other corporate portfolios.

Ulster Bank Group is assisting customers in this difficult environment. Mortgage forbearance policies which are deployed through the 'Flex' initiative are aimed at assisting customers in financial difficulty.

Non-Core

The Q3 2011 impairment charge was £281 million (Q3 2010 - £676 million) with the commercial real estate sector accounting for £236 million (84%) of the total Q3 2011 charge. The impairment charge decreased from £977 million in Q2 2011 to £281 million in Q3 2011, primarily reflecting a slower rate of deterioration in security values and a reduction in the value of loans defaulting.

Risk and balance sheet management (continued)

Risk management: Credit risk: Ulster Bank Group (Core and Non-Core) (continued)

Loans, REIL and impairments by sector

30 September 2011	Gross loans (1)	REIL	Provisions	REIL as a % of gross loans	Provisions as a % of REIL	Provisions as a % of gross loans	Q3 Impairment charge	Q3 Amounts written-off
	£m	£m	£m	%	%	%	£m	£m
Core								
Mortgages	20,692	2,138	852	10.3	40	4.1	126	-
	1,557	201	182	12.9	91	11.7	12	4

Personal unsecured								
Commercial real estate								
- investment	4,241	1,163	373	27.4	32	8.8	58	-
- development	923	261	135	28.3	52	14.6	20	-
Other corporate	8,133	1,793	1,025	22.0	57	12.6	111	37
	35,546	5,556	2,567	15.6	46	7.2	327	41
Non-Core								
Commercial real estate								
- investment	3,937	2,684	1,247	68.2	47	31.7	74	1
- development	8,703	7,687	4,342	88.3	57	49.9	162	1
Other corporate	1,670	1,176	674	70.4	57	40.4	45	9
	14,310	11,547	6,263	80.7	54	43.8	281	11
Ulster Bank Group								
Mortgages	20,692	2,138	852	10.3	40	4.1	126	-
Personal unsecured	1,557	201	182	12.9	91	11.7	12	4
Commercial real estate								
- investment	8,178	3,847	1,620	47.0	42	19.8	132	1
- development	9,626	7,948	4,477	82.6	56	46.5	182	1
Other corporate	9,803	2,969	1,699	30.3	57	17.3	156	46
	49,856	17,103	8,830	34.3	52	17.7	608	52

Note:

(1) Funded customer loans.

Risk and balance sheet management (continued)

Risk management: Credit risk: Ulster Bank Group (Core and Non-Core) (continued)

Loans, REIL and impairments by sector (continued)

30 June 2011	Gross loans £m	REIL £m	Provisions £m	REIL as a % of gross loans %	Provisions as a % of REIL %	Provisions as a % of gross loans %	H1 Impairment charge £m	H1 Amounts written-off £m

Core								
Mortgages	21,778	2,014	769	9.2	38	3.5	311	4
Personal unsecured	1,605	201	181	12.5	90	11.3	33	15
Commercial real estate								
- investment	4,338	838	331	19.3	40	7.6	115	-
- development	955	241	120	25.2	50	12.6	48	-
Other corporate	8,699	1,822	1,000	20.9	55	11.5	223	2
	37,375	5,116	2,401	13.7	47	6.4	730	21
Non-Core								
Commercial real estate								
- investment	4,076	2,662	1,231	65.3	46	30.2	384	-
- development	9,002	7,847	4,367	87.2	56	48.5	1,313	-
Other corporate	1,811	1,226	661	67.7	54	36.5	113	2
	14,889	11,735	6,259	78.8	53	42.0	1,810	2
Ulster Bank Group								
Mortgages	21,778	2,014	769	9.2	38	3.5	311	4
Personal unsecured	1,605	201	181	12.5	90	11.3	33	15
Commercial real estate								
- investment	8,414	3,500	1,562	41.6	45	18.6	499	-
- development	9,957	8,088	4,487	81.2	56	45.1	1,361	-
Other corporate	10,510	3,048	1,661	29.0	55	15.8	336	4
	52,264	16,851	8,660	32.2	51	16.6	2,540	23

Risk and balance sheet management (continued)

Risk management: Credit risk: Ulster Bank Group (Core and Non-Core) (continued)

Loans, REIL and impairments by sector (continued)

	Gross loans £m	REIL £m	Provisions £m	REIL as a % of gross loans %	Provisions as a % of REIL %	Provisions as a % of gross loans %	Q4 Impairment charge £m	Q4 Amounts written-off £m

31 December 2010								
Core								
Mortgages	21,162	1,566	439	7.4	28	2.1	159	3
Personal unsecured	1,282	185	158	14.4	85	12.3	13	6
Commercial real estate								
- investment	4,284	598	332	14.0	56	7.7	79	-
- development	1,090	65	37	6.0	57	3.4	(10)	-
Other corporate	9,039	1,205	667	13.3	55	7.4	135	1
	36,857	3,619	1,633	9.8	45	4.4	376	10
Non-Core								
Commercial real estate								
- investment	3,854	2,391	1,000	62.0	42	25.9	206	-
- development	8,760	6,341	2,783	72.4	44	31.8	596	-
Other corporate	1,970	1,310	561	66.5	43	28.5	(19)	-
	14,584	10,042	4,344	68.9	43	29.8	783	-
Ulster Bank Group								
Mortgages	21,162	1,566	439	7.4	28	2.1	159	3
Personal unsecured	1,282	185	158	14.4	85	12.3	13	6
Commercial real estate								
- investment	8,138	2,989	1,332	36.7	45	16.4	285	-
- development	9,850	6,406	2,820	65.0	44	28.6	586	-
Other corporate	11,009	2,515	1,228	22.8	49	11.2	116	1
	51,441	13,661	5,977	26.6	44	11.6	1,159	10

Key points

· The REIL increase of £252 million in Q3 2011 reflects continuing difficult conditions in both the commercial and residential sectors in the Republic of Ireland partially offset by currency movements. Of the REIL at 30 September 2011, 68% was in Non-Core (30 June 2011 - 70%).

· The majority of Non-Core commercial real estate development portfolio (88%) is REIL with a 57% provision coverage.

· REIL mortgages represented 10.3% of gross lending at 30 September 2011 compared with 9.2% at 30 June 2011 and 7.4% at 31 December 2010.

Risk management: Credit risk: Ulster Bank Group (Core and Non-Core) (continued)

Residential mortgages

The table below shows how the continued decrease in property values has affected the distribution of residential mortgages by loan-to-value (LTV) (indexed). LTV is based upon gross loan amounts and, whilst including defaulted loans, does not take account of provisions made.

By average LTV (1)	30 September 2011 %	30 June 2011 %	31 December 2010 %
<= 50%	33.7	35.1	35.9
> 50% and <= 70%	12.5	13.0	13.5
> 70% and <= 90%	12.4	13.0	13.5
> 90%	41.4	38.9	37.1
Total portfolio average LTV	77.6	74.5	71.2
Average LTV on new originations during the period	66.7	65.0	75.9

Note:

(1) LTV averages calculated by transaction volume.

Key points

- The residential mortgage portfolio across Ulster Bank Group totalled £20.7 billion at 30 September 2011 with 89% in the Republic of Ireland and 11% in Northern Ireland. At constant exchange rates, the portfolio remained at similar levels to 31 December 2010 (c.£21.2 billon) with little growth due to low new business volumes.

- Repossession levels remain low at 134 cases in the nine months ended 30 September 2011, of which 111 were in the Republic of Ireland, primarily due to voluntary surrender or abandonment of the property.

Risk management: Credit risk: Ulster Bank Group (Core and Non-Core) (continued)

Commercial real estate

The commercial real estate lending portfolio in Ulster Bank Group reduced during the quarter to £17.8 billion, primarily due to exchange rate movements. The Non-Core portion of the portfolio totalled £12.6 billion (71% of the portfolio). Of the total Ulster Bank Group commercial real estate portfolio, the geographic split remains similar to last quarter with, 62% relating to the Republic of Ireland, 26% to Northern Ireland and 12% to the rest of the UK.

	Development		Investment		
	Commercial	Residential	Commercial	Residential	Total
Exposure by geography	£m	£m	£m	£m	£m
30 September 2011					
Ireland (ROI & NI)	2,674	6,479	5,225	1,174	15,552
UK (excluding Northern Ireland)	97	357	1,659	108	2,221
RoW	-	19	8	4	31
	2,771	6,855	6,892	1,286	17,804
30 June 2011					
Ireland (ROI & NI)	2,762	6,701	5,378	1,210	16,051
UK (excluding Northern Ireland)	104	358	1,702	112	2,276
RoW	4	28	8	4	44
	2,870	7,087	7,088	1,326	18,371
31 December 2010					
Ireland (ROI & NI)	2,785	6,578	5,072	1,098	15,533
UK (excluding Northern Ireland)	110	359	1,831	115	2,415
RoW	-	18	22	-	40
	2,895	6,955	6,925	1,213	17,988

Note:

(1) The above table does not include rate risk management or contingent obligations.

Key point

- Commercial real estate remains the primary driver of the increase in the defaulted loan book for Ulster Bank. The outlook for the sector remains uncertain with the possibility of further declines in values. Proactive management of the portfolio has resulted in further transfers of stressed customers to the specialised management of Global Restructuring Group.

Risk and balance sheet management (continued)

Market risk

Market risk arises from changes in interest rates, foreign currency, credit spread, equity prices and risk related factors such as market volatilities. The Group manages market risk centrally within its trading and non-trading portfolios through a comprehensive market risk management framework. This framework includes limits based on, but not limited to, value-at-risk (VaR), stress testing, position and sensitivity analyses.

For a description of the Group's basis of measurement and methodology limitations, refer to the 2010 Annual Report and Accounts, Market risk, page 193.

Daily distribution of GBM trading revenues

http://www.rns-pdf.londonstockexchange.com/rns/4912R_-2011-11-3.pdf

Note:

(1) The effect of any month end adjustments, not attributable to a specific daily market move, is spread evenly over the days in the month in question.

Risk and balance sheet management (continued)

Market risk (continued)

Key points

Nine months ended 30 September 2011 compared with nine months ended 30 September 2010

· GBM traded revenue decreased during 2011 due to the ongoing European sovereign debt crisis and heightened concerns about growth expectations for the world economy.

· The average daily revenue earned from Core trading activities in 2011 was £22 million, compared with £29 million in 2010. The standard deviation of these daily revenues was £21 million, unchanged period on period.

· The number of days with negative revenue increased from 11 days in 2010 to 24 days in 2011 due to market and economic conditions referred to above.

· The most frequent result is daily revenue in the range of £25 million to £30 million with 24 occurrences in 2011, compared with 32 occurrences in 2010.

The table below details VaR for the Group's trading portfolio, segregated by type of market risk exposure, and between Core and Non-Core, Counterparty Exposure Management (CEM) and Core excluding CEM.

	Quarter ended							
	30 September 2011				30 June 2011			
	Average	Period end	Maximum	Minimum	Average	Period end	Maximum	Minimum
Trading VaR	£m	£m	£m	£m	£m	£m	£m	£m
Interest rate	51.3	73.0	73.1	33.1	39.4	36.8	75.7	27.5
Credit spread	56.2	69.8	69.8	47.4	73.2	64.6	95.0	60.0
Currency	8.7	6.5	12.5	6.1	9.4	9.3	14.2	5.2
Equity	7.9	7.7	13.1	4.6	10.4	12.0	17.3	5.2
Commodity	0.9	3.6	3.6	0.1	0.2	0.3	1.6	-
Diversification		(54.3)				(61.0)		

Total	78.3	106.3	114.2	59.7	78.7	62.0	117.9	60.8
Core	58.3	83.1	91.0	41.7	60.2	42.5	86.0	42.5
Core CEM	34.4	38.0	45.2	23.5	26.5	23.2	33.2	21.9
Core excluding CEM	44.3	62.2	71.4	35.3	57.1	39.4	78.4	39.2
Non-Core	40.4	38.7	53.0	33.2	69.3	51.4	110.1	47.5

Key points

Q3 2011 compared with Q2 2011

- The Group's total trading VaR and interest rate VaR were significantly higher at the end of Q3 2011 than at end Q2 2011. This was largely driven by hedge positions for a large and successful UK gilt syndication in which RBS participated.

- Average credit spread VaR and Non-Core trading VaR was considerably lower in Q3 2011 than in Q2 2011. Non-Core VaR decreased substantially during Q2 primarily due to a significant de-risking of the portfolios in line with the overall business strategy. The VaR continued to decline as the period of high volatility relating to the 2008/2009 credit crisis dropped out of the VaR calculations.

Risk and balance sheet management (continued)

Market risk (continued)

Key points (continued)

- The credit spread period end VaR was slightly higher in Q3 2011 than in Q2 2011. This was largely due to the recent volatility in the European sovereign peripheral time series entering the VaR window.

- The CEM trading VaR increased in Q3 2011 due to the implementation of an enhanced discounting methodology for cross-currency trades.

	Nine months ended							
	30 September 2011				30 September 2010			
	Average	Period end	Maximum	Minimum	Average	Period end	Maximum	Minimum
Trading VaR	£m	£m	£m	£m	£m	£m	£m	£m
Interest rate	50.3	73.0	79.2	27.5	47.7	74.3	74.3	32.5
Credit spread	87.4	69.8	151.1	47.4	177.1	190.8	243.2	113.0
Currency	10.1	6.5	18.0	5.2	18.9	16.7	28.0	9.3
Equity	9.8	7.7	17.3	4.6	9.3	5.4	17.9	2.7
Commodity	0.4	3.6	3.6	-	10.1	13.8	15.8	3.2

Diversification		(54.3)				(119.2)		
Total	104.1	106.3	181.3	59.7	173.3	181.8	252.1	103.0
Core	75.3	83.1	133.9	41.7	105.1	115.0	153.4	58.9
Core CEM	33.6	38.0	47.6	21.9	55.1	73.0	82.4	30.3
Core excluding CEM	62.9	62.2	106.2	35.3	83.2	78.4	108.7	53.6
Non-Core	74.2	38.7	128.6	33.2	105.7	101.8	169.4	63.2

Key point

Nine months ended 30 September 2011 compared with nine months ended 30 September 2010

- The Group's market risk profile in 2010 was equally split across Non-Core and Core divisions with a concentrated exposure to the credit spread risk factor. In line with the business strategy to wind down the Group's interest in Sempra and other Non-Core activities, the trading portfolio has now been re-balanced such that the Non-Core exposure has been significantly reduced and the trading portfolio is less concentrated in the credit risk factor.

Risk and balance sheet management (continued)

Market risk (continued)

The table below details VaR for the Group's non-trading portfolio, excluding the structured portfolio (SCP) and loans and receivables (LAR), segregated by type of market risk exposure and between Core and Non-Core.

	Quarter ended							
	30 September 2011				30 June 2011			
	Average	Period end	Maximum	Minimum	Average	Period end	Maximum	Minimum
Non-trading VaR	£m	£m	£m	£m	£m	£m	£m	£m
Interest rate	9.6	10.3	11.1	8.2	8.3	8.3	9.2	5.7
Credit spread	16.0	14.8	18.0	14.1	19.1	18.0	24.2	16.1
Currency	3.0	4.1	5.9	1.1	1.7	3.3	3.3	0.2
Equity	1.9	1.8	2.0	1.6	2.2	2.0	2.4	2.0
Diversification		(13.5)				(13.1)		
Total	17.6	17.5	18.9	15.7	18.7	18.5	22.5	16.7
Core	17.4	18.6	20.1	15.2	18.5	19.4	24.6	15.7
Non-Core	3.9	3.7	4.3	3.2	3.7	4.3	4.3	2.8

Key point

Q3 2011 compared with Q2 2011

· The maximum credit spread VaR was lower in Q3 2011 than in Q2 2011. This was primarily due to the increased market volatility experienced during the 2008/2009 credit crisis, dropping out of the two year time series used by the VaR model. This volatility was particularly pronounced in respect of credit spreads and had a marked impact on historic credit spread VaR.

	Nine months ended							
	30 September 2011				30 September 2010 (1)			
	Average	Period end	Maximum	Minimum	Average	Period end	Maximum	Minimum
Non-trading VaR	£m	£m	£m	£m	£m	£m	£m	£m
Interest rate	8.6	10.3	11.1	5.7	8.9	4.4	20.5	4.4
Credit spread	19.6	14.8	39.3	14.1	37.1	19.4	101.2	19.4
Currency	1.8	4.1	5.9	0.1	2.1	2.0	7.6	0.3
Equity	2.2	1.8	3.1	1.6	0.6	0.4	3.5	0.2
Diversification		(13.5)				(6.8)		
Total	20.9	17.5	41.6	13.4	35.8	19.4	98.0	19.4
Core	20.4	18.6	38.9	13.5	35.5	19.3	98.1	19.3
Non-Core	3.4	3.7	4.3	2.2	0.8	0.3	3.6	0.2

Note:

(1) Revised to exclude LAR portfolios.

Key point

Nine months ended 30 September 2011 compared with nine months ended 30 September 2010

· The maximum credit spread VaR was considerably lower in 2011 than in the same period in 2010. This was due to a change in the time series used for the Dutch RMBS portfolio in RBS N.V. where more relevant and granular market data had become available and provided a better reflection of the risk in the portfolio. The VaR decreased through the period as the volatile market data continued to drop out of the 500 day time series used in the VaR calculation.

Risk and balance sheet management (continued)

Market risk (continued)

Structured Credit Portfolio (SCP)

Drawn notional					Fair value				
CDOs	CLOs	MBS (1)	Other ABS	Total	CDOs	CLOs	MBS (1)	Other ABS	Total

	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
30 September 2011										
1-2 years	-	-	29	36	65	-	-	28	31	59
2-3 years	-	-	5	172	177	-	-	4	160	164
3-4 years	6	-	6	43	55	5	-	5	40	50
4-5 years	-	39	-	95	134	-	36	-	88	124
5-10 years	32	517	317	277	1,143	30	469	230	242	971
>10 years	1,296	454	470	593	2,813	228	394	314	349	1,285
	1,334	1,010	827	1,216	4,387	263	899	581	910	2,653
30 June 2011										
1-2 years	-	-	45	46	91	-	-	44	41	85
2-3 years	11	-	-	183	194	10	-	-	170	180
3-4 years	5	-	11	48	64	5	-	10	46	61
4-5 years	-	15	-	56	71	-	14	-	53	67
5-10 years	95	396	315	365	1,171	84	370	245	322	1,021
>10 years	390	498	551	526	1,965	167	420	391	388	1,366
	501	909	922	1,224	3,556	266	804	690	1,020	2,780
31 December 2010										
1-2 years	-	-	-	47	47	-	-	-	42	42
2-3 years	85	19	44	98	246	81	18	37	91	227
3-4 years	-	41	20	205	266	-	37	19	191	247
4-5 years	16	-	-	-	16	15	-	-	-	15
5-10 years	98	466	311	437	1,312	87	422	220	384	1,113
>10 years	412	663	584	550	2,209	161	515	397	367	1,440
	611	1,189	959	1,337	4,096	344	992	673	1,075	3,084

Note:

(1) MBS include sub-prime RMBS with a notional amount of £406 million (30 June 2011 - £451 million; 31 December 2010 - £471 million) and a fair value of £274 million (30 June 2011 - £325 million; 31 December 2010 - £329 million), all with residual maturities of greater than 10 years.

The SCP non-trading risk in Non-Core is not measured using VaR as the Group believes this is not an appropriate tool for this portfolio of illiquid debt securities. The fair value and drawn notional are represented on a net basis.

The increase in drawn notional for CDOs and CLOs at the quarter ended 30 September 2011 was due to the exposure to legacy positions in the banking book portfolio. These positions were previously hedged, with both positions and hedges marked at fair value, well below their notional values. The hedges that were considered to be ineffective were removed in Q3 2011, resulting in a large increase in net notional values but only a small increase in net fair values.

Additional information

	30 September 2011	30 June 2011	31 December 2010
Ordinary share price	£0.235	£0.385	£0.391
Number of ordinary shares in issue	59,228m	59,226m	58,458m
Market capitalisation (including B shares)	£25.9bn	£42.4bn	£42.8bn

Statutory results
Financial information contained in this document does not constitute statutory accounts within the meaning of section 434 of the Companies Act 2006 ('the Act'). The statutory accounts for the year ended 31 December 2010 have been filed with the Registrar of Companies. The report of the auditor on those statutory accounts was unqualified, did not draw attention to any matters by way of emphasis and did not contain a statement under section 498(2) or (3) of the Act.

These third quarter 2011 results have not been audited or reviewed by the auditors.

Financial calendar

2011 annual results announcement	Thursday 23 February 2012
2012 first quarter interim management statement	Friday 4 May 2012

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: 4 November 2011

THE ROYAL BANK OF
SCOTLAND GROUP plc
(Registrant)

By: /s/ Jan Cargill

Name: Jan Cargill
Title: Deputy Secretary