CLIFFS NATURAL RESOURCES INC.
Form 10-Q
October 31, 2008
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2008

OR

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

For the transition period from ______ to ______.

Commission File Number: 1-8944

CLIFFS NATURAL RESOURCES INC.

(Exact Name of Registrant as Specified in Its Charter)

Ohio	34-1464672
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

1100 Superior Avenue, Cleveland, Ohio 44114-2544

(Address of Principal Executive Offices) (Zip Code)

Registrant s Telephone Number, Including Area Code: (216) 694-5700

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES __X__ NO ___

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer __X__	Accelerated filer ____
Non-accelerated filer ______	Smaller reporting company____

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES ____ NO __X__

As of October 27, 2008, there were 113,502,463 Common Shares (par value $0.125 per share) outstanding.

Table of Contents

TABLE OF CONTENTS

Page No.	
3	Definitions
	PART I FINANCIAL INFORMATION
4	Item 1 Financial Statements
	Statements of Unaudited Condensed Consolidated Operations
	Three and Nine Months Ended September 30, 2008 and 2007
5	Statements of Condensed Consolidated Financial Position
	September 30, 2008 (unaudited) and December 31, 2007
6	Statements of Unaudited Condensed Consolidated Cash Flows
	Nine Months Ended September 30, 2008 and 2007
7	Notes to Unaudited Condensed Consolidated Financial Statements
40	Item 2 Management s Discussion and Analysis of
	Financial Condition and Results of Operations
59	Item 3 Quantitative and Qualitative Disclosures About Market Risk
59	Item 4 Controls and Procedures
	PART II OTHER INFORMATION AND SIGNATURES
60	Item 1 Legal Proceedings
64	Item 1A Risk Factors
66	Item 2 Unregistered Sales of Equity Securities and Use of Proceeds
67	Item 6 Exhibits
67	Signature
68	Exhibit Index

EX-31(a) Section 302 Certification of Chief Executive Officer

EX-31(b) Section 302 Certification of Chief Financial Officer

EX-32(a) Section 906 Certification of Chief Executive Officer

EX-32(b) Section 906 Certification of Chief Financial Officer

Table of Contents

Definitions

The following abbreviations or acronyms are used in the text. References in this report to the Company, we, us, our and Cliffs to Cliffs Natural Resources Inc. (formerly known as Cleveland-Cliffs Inc) and subsidiaries, collectively. References to A$ refer to Australian currency, C$ to Canadian currency and $ to United States currency.

Abbreviation or acronym	Term
AAA	American Arbitration Association
Alpha or ANR	Alpha Natural Resources, Inc.
Amapá	MMX Amapá Mineração Limitada
ArcelorMittal	ArcelorMittal USA Inc.
ASX	Australian Stock Exchange
CAWO	Cliffs Australian Washplant Operations Pty Ltd
Cockatoo Island	Cockatoo Island Joint Venture
Dofasco	ArcelorMittal Dofasco Inc.
EITF	Emerging Issues Task Force
Empire	Empire Iron Mining Partnership
EPA	United States Environmental Protection Agency
FASB	Financial Accounting Standards Board
F.O.B.	Free on board
FSP	FASB Staff Position
GAAP	Accounting principles generally accepted in the United States
Golden West	Golden West Resources Ltd.
Harbinger	Harbinger Capital Partners
Hibbing	Hibbing Taconite Company
ICE Plan	Incentive Equity Plan
Kobe Steel	Kobe Steel, LTD.
LIBOR	London Interbank Offered Rate
LTVSMC	LTV Steel Mining Company
MD&A	Management s Discussion and Analysis of Financial Condition and Results of Operations
MMBTU	Million British Thermal Units
MMX	MMX Mineração e Metálicos S.A.
MPCA	Minnesota Pollution Control Agency
MSHA	Mine Safety and Health Administration
NPDES	National Pollutant Discharge Elimination System
Northshore	Northshore Mining Company
NRD	Natural Resource Damages
Oak Grove	Oak Grove Resources, LLC
OPEB	Other postretirement benefits
Pinnacle	Pinnacle Mining Company, LLC
PinnOak	PinnOak Resources, LLC
Portman	Portman Limited
PCAOB	Public Company Accounting Oversight Board
Renewafuel	Renewafuel, LLC
RTWG	Rio Tinto Working Group
SEC	United States Securities and Exchange Commission
Severstal	Severstal North America, Inc.
SFAS	Statement of Financial Accounting Standards
Sonoma	Sonoma Coal Project
Tilden	Tilden Mining Company L.C.
Tonne	Metric ton
USW	United Steelworkers
United Taconite	United Taconite LLC
VEBA	Voluntary Employee Benefit Association trusts
VNQDC Plan	Voluntary Non-Qualified Deferred Compensation Plan

Wabush	Wabush Mines Joint Venture

Table of Contents

PART I - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

CLIFFS NATURAL RESOURCES INC. AND SUBSIDIARIES

STATEMENTS OF UNAUDITED CONDENSED CONSOLIDATED OPERATIONS

	(In Millions, Except Per Share Amounts)			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
REVENUES FROM PRODUCT SALES AND SERVICES				
Product	$ 1,110.8	$ 542.4	$ 2,444.4	$ 1,283.2
Freight and venture partners cost reimbursements	78.9	77.2	248.4	209.5
	1,189.7	619.6	2,692.8	1,492.7
COST OF GOODS SOLD AND OPERATING EXPENSES	(824.7)	(512.3)	(1,819.0)	(1,194.0)
SALES MARGIN	365.0	107.3	873.8	298.7
OTHER OPERATING INCOME (EXPENSE)				
Casualty recoveries	0.5	-	10.5	3.2
Royalties and management fee revenue	5.1	4.1	16.0	10.3
Selling, general and administrative expenses	(41.8)	(33.2)	(138.4)	(75.4)
Gain on sale of other assets	0.1	-	21.1	-
Miscellaneous - net	10.5	3.7	8.6	5.9
	(25.6)	(25.4)	(82.2)	(56.0)
OPERATING INCOME	339.4	81.9	791.6	242.7
OTHER INCOME (EXPENSE)				
Changes in fair value of derivative instruments, net	(94.3)	-	(94.3)	-
Interest income	5.9	5.6	17.8	15.5
Interest expense	(10.7)	(7.9)	(27.7)	(11.0)
Other - net	3.3	0.1	3.4	1.7
	(95.8)	(2.2)	(100.8)	6.2
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES, MINORITY INTEREST AND EQUITY LOSS FROM VENTURES	243.6	79.7	690.8	248.9
PROVISION FOR INCOME TAXES	(52.0)	(17.5)	(173.6)	(56.8)
MINORITY INTEREST (net of tax of $1.5, $1.6, $12.5 and $5.4)	(3.6)	(3.7)	(29.1)	(12.7)
EQUITY LOSS FROM VENTURES	(13.1)	(1.6)	(26.2)	(3.1)
NET INCOME	174.9	56.9	461.9	176.3
PREFERRED STOCK DIVIDENDS	-	(1.4)	(1.1)	(4.2)
INCOME APPLICABLE TO COMMON SHARES	$ 174.9	$ 55.5	$ 460.8	$ 172.1
EARNINGS PER COMMON SHARE - BASIC	$ 1.67	$ 0.67	$ 4.72	$ 2.11
EARNINGS PER COMMON SHARE - DILUTED	$ 1.61	$ 0.54	$ 4.34	$ 1.69

AVERAGE NUMBER OF SHARES (IN THOUSANDS)				
Basic	**104,753**	**82,586**	**97,605**	**81,782**
Diluted	**108,719**	**105,000**	**106,439**	**104,668**

See notes to unaudited condensed consolidated financial statements.

4

Table of Contents

CLIFFS NATURAL RESOURCES INC. AND SUBSIDIARIES

STATEMENTS OF CONDENSED CONSOLIDATED FINANCIAL POSITION

	(In Millions)	
ASSETS	September 30, 2008 (Unaudited)	December 31, 2007
CURRENT ASSETS		
Cash and cash equivalents	$ 388.3	$ 157.1
Accounts receivable	137.8	84.9
Inventories	327.2	241.9
Supplies and other inventories	86.7	77.0
Derivative assets	140.2	69.5
Other	132.0	124.2
TOTAL CURRENT ASSETS	1,212.2	754.6
PROPERTY, PLANT AND EQUIPMENT LESS ACCUMULATED DEPRECIATION AND DEPLETION - $429.9 ($330.9 in 2007)	2,518.9	1,823.9
OTHER ASSETS		
Investments in ventures	264.2	265.3
Marketable securities	62.8	55.7
Long term receivables	33.1	38.0
Goodwill	21.3	11.8
Intangible assets, net	91.5	-
Other	105.2	126.5
TOTAL OTHER ASSETS	578.1	497.3
TOTAL ASSETS	$ 4,309.2	$ 3,075.8
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 194.6	$ 149.9
Deferred revenue	181.3	28.4
Amounts due to former owners of PinnOak	279.1	-
Unregistered common shares issued	165.0	-
Accrued employment costs	80.9	73.2
Accrued expenses	83.7	50.1
Income taxes payable	49.5	11.5
Derivative liabilities	38.4	1.4
Other	71.3	85.1
TOTAL CURRENT LIABILITIES	1,143.8	399.6
PENSIONS AND OTHER POSTRETIREMENT BENEFITS	186.1	204.8
ENVIRONMENTAL AND MINE CLOSURE OBLIGATIONS	123.6	123.2
DEFERRED INCOME TAXES	198.4	189.0
SENIOR NOTES	325.0	-
TERM LOAN	200.0	200.0
REVOLVING CREDIT	-	240.0
CONTINGENT CONSIDERATION	-	99.5
DEFERRED PAYMENT	-	96.2
BELOW-MARKET SALES CONTRACTS	221.3	-
OTHER LIABILITIES	153.3	107.3
TOTAL LIABILITIES	2,551.5	1,659.6
MINORITY INTEREST	69.2	117.8
COMMITMENTS AND CONTINGENCIES		
3.25% REDEEMABLE CUMULATIVE CONVERTIBLE PERPETUAL PREFERRED STOCK - ISSUED 172,500 SHARES OUTSTANDING 205 AND 134,715 IN 2008 AND 2007	0.2	134.7

SHAREHOLDERS EQUITY		
Common Shares - par value $0.125 a share Authorized - 224,000,000 shares; Issued - 134,623,528 shares Outstanding - 106,720,611 shares (net of treasury shares)	**16.8**	**16.8**
Capital in excess of par value of shares	**161.8**	**116.6**
Retained earnings	**1,756.3**	**1,316.2**
Cost of 27,902,917 Common Shares in treasury (2007 - 47,455,922 shares)	**(158.6)**	**(255.6)**
Accumulated other comprehensive loss	**(88.0)**	**(30.3)**
TOTAL SHAREHOLDERS EQUITY	**1,688.3**	**1,163.7**
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**$ 4,309.2**	**$ 3,075.8**

See notes to unaudited condensed consolidated financial statements.

Table of Contents

CLIFFS NATURAL RESOURCES INC. AND SUBSIDIARIES

STATEMENTS OF UNAUDITED CONDENSED CONSOLIDATED CASH FLOWS

	(In Millions) Nine Months Ended September 30,	
	2008	2007
CASH FLOW FROM OPERATIONS		
OPERATING ACTIVITIES:		
Net income	$ 461.9	$ 176.3
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion and amortization	129.2	71.1
Minority interest, net	29.1	12.7
Tax contingency reserve	14.5	2.7
Equity loss in ventures	26.2	3.1
Share-based compensation	15.4	6.7
Derivatives and currency hedging	(26.0)	(7.2)
(Gain) loss on sale of assets	(12.7)	1.2
Property damage recoveries	(10.5)	-
Excess tax benefit from share-based compensation	(3.3)	(4.0)
Deferred income taxes	(2.6)	(22.8)
Pensions and other postretirement benefits	(28.4)	(34.9)
Environmental and closure obligations	1.1	1.7
Other	5.1	(2.2)
Changes in operating assets and liabilities:		
Product inventories	(48.9)	(129.2)
Receivables and all other assets	(76.3)	53.1
Payables and accrued expenses	108.4	(47.3)
Net cash provided by operating activities	582.2	81.0
INVESTING ACTIVITIES:		
Purchase of property, plant and equipment	(147.7)	(64.5)
Purchase of minority interest in Portman	(137.8)	-
Purchase of minority interest in United Taconite	(104.4)	-
Investment in marketable securities	(30.7)	(53.6)
Investments in ventures	(20.3)	(272.7)
Purchase of PinnOak	-	(343.8)
Proceeds from sale of assets	39.5	3.2
Redemption of marketable securities	17.7	17.7
Proceeds from property damage insurance recoveries	10.5	-
Net cash used by investing activities	(373.2)	(713.7)
FINANCING ACTIVITIES:		
Borrowings under revolving credit facility	370.0	1,105.0
Repayment under revolving credit facility	(610.0)	(715.0)
Repayment of PinnOak debt	-	(159.6)
Borrowings under senior notes	325.0	-
Borrowings under term loans	-	200.0
Excess tax benefit from share-based compensation	3.3	4.0
Contributions by (to) joint ventures, net	0.9	1.7
Common stock dividends	(26.1)	(15.5)
Preferred stock dividends	(2.2)	(4.2)
Repayment of other borrowings	(7.7)	(5.0)
Proceeds from stock options exercised	-	0.1

Repurchases of common stock		**-**		**(2.2)**
Issuance costs of revolving credit		**-**		**(1.0)**
Net cash from financing activities		**53.2**		**408.3**
EFFECT OF EXCHANGE RATE CHANGES ON CASH		**(31.0)**		**12.3**
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS		**231.2**		**(212.1)**
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD		**157.1**		**351.7**
CASH AND CASH EQUIVALENTS AT END OF PERIOD	**$**	**388.3**	**$**	**139.6**

See notes to unaudited condensed consolidated financial statements.

6

Table of Contents

CLIFFS NATURAL RESOURCES INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2008

NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with SEC rules and regulations and in the opinion of management, contain all adjustments (consisting of normal recurring adjustments) necessary to present fairly, the financial position, results of operations and cash flows for the periods presented. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. The interim results are not necessarily indicative of results for the full year. These unaudited condensed consolidated financial statements should be read in conjunction with the financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2007. All common shares and per share amounts have been adjusted retroactively to reflect the two-for-one stock split effective May 15, 2008.

The unaudited condensed consolidated financial statements include our accounts and the accounts of our consolidated subsidiaries, including the following significant subsidiaries:

Name	Location	Ownership Interest	Operation
Northshore	Minnesota	100.0%	Iron Ore
United Taconite	Minnesota	100.0%	Iron Ore
Pinnacle	West Virginia	100.0%	Coal
Oak Grove	Alabama	100.0%	Coal
Portman	Western Australia	85.2%	Iron Ore
Tilden	Michigan	85.0%	Iron Ore
Empire	Michigan	79.0%	Iron Ore

Intercompany accounts are eliminated upon consolidation.

On May 21, 2008, Portman authorized a tender offer to repurchase up to 16.5 million shares, or 9.39 percent of its common stock. On this date, we owned 80.4 percent of the approximately 176 million shares outstanding in Portman and indicated we would not participate in the tender buyback. The tender period closed on June 24, 2008. Under the buyback, 9.8 million fully paid ordinary shares were tendered at a price of $14.10 (A$14.66) per share. The total consideration paid under the buyback was $137.8 million (A$143.3 million), with our share totaling $110.8 million (A$115.2 million) based on our ownership percentage at the time. As a result of the buyback, our ownership interest in Portman increased from 80.4 percent to 85.2 percent. In order to enable us to move to full ownership of Portman, on September 10, 2008, we announced an off-market takeover offer to acquire, through our wholly-owned subsidiary, Cliffs Asia-Pacific Pty Limited, all of the shares in Portman that we do not already own. The offer is a last and final cash offer at a price of $17.65 (A$21.50) per Portman share. See NOTE 4 ACQUISITIONS & OTHER INVESTMENTS and NOTE 19 SUBSEQUENT EVENTS for further information.

7

Effective July 1, 2008, we acquired the remaining 30 percent interest in United Taconite. Upon consummation of the purchase, our ownership interest increased from 70 percent to 100 percent. Total consideration paid for the acquisition was approximately $450.7 million, which is comprised of $104.4 million in cash, 4.3 million of our common shares, and 1.2 million tons of iron ore pellets to be provided throughout 2008 and 2009. The consolidation of the United Taconite minority interest, together with our Northshore property, represents two wholly-owned iron ore subsidiaries in North America. See NOTE 4 ACQUISITIONS & OTHER INVESTMENTS and NOTE 19 SUBSEQUENT EVENTS for further information.

Through various interrelated arrangements, we achieve a 45 percent economic interest in Sonoma, despite the ownership percentages of the individual pieces of Sonoma. We own 100 percent of CAWO, 8.33 percent of the exploration permits and applications for mining leases for the real estate that is involved in Sonoma (Mining Assets) and 45 percent of the infrastructure, including the construction of a rail loop and related equipment (Non-Mining Assets). CAWO is consolidated as a wholly-owned subsidiary, and as a result of being the primary beneficiary, we absorb greater than 50 percent of the residual returns and expected losses of CAWO. We record our ownership share of the Mining Assets and Non-Mining Assets and share in the respective costs.

Our investments in ventures include our 30 percent equity interest in Amapá, an iron ore project located in Brazil, our 23 percent equity interest in Hibbing, an unincorporated joint venture in Minnesota, our 26.83 percent equity interest in Wabush, an unincorporated joint venture located in Canada, and Portman s 50 percent non-controlling interest in Cockatoo Island.

Investments in certain joint ventures (Wabush, Cockatoo Island, Hibbing) in which our ownership is 50 percent or less, or in which we do not have control but have the ability to exercise significant influence over operating and financial policies, are accounted for under the equity method. Our share of equity income (loss) is eliminated against consolidated product inventory upon production, and against cost of goods sold and operating expenses when sold. This effectively reduces our cost for our share of the mining venture s production to its cost, reflecting the cost-based nature of our participation in unconsolidated ventures.

Our 30 percent ownership interest in Amapá, in which we do not have control but have the ability to exercise influence over operating and financial policies, is accounted for under the equity method. Accordingly, our share of the results from Amapá is reflected as *Equity loss from ventures* on the Statements of Unaudited Condensed Consolidated Operations.

The following table presents the detail of our investments in ventures and where those investments are classified on the Statements of Condensed Consolidated Financial Position. Parentheses indicate a net liability.

Investment	Classification	Interest Percentage	(In Millions) September 30, 2008	December 31, 2007
Amapá	*Investments in ventures*	30	$ 254.5	$ 247.2
Wabush	*Investments in ventures*	27	(1.1)	5.8
Cockatoo	*Other liabilities*	50	(17.2)	(9.9)
Hibbing [1]	*Investments in ventures*	23	1.4	(0.3)
Other	*Investments in ventures*		9.4	12.3
			$ 247.0	$ 255.1

(1) Recorded as *Other liabilities* at December 31, 2007.

The increase in the liability related to Cockatoo is primarily attributable to an increase in the estimated asset retirement obligation in connection with a revised assessment of the mine closure plan.

NOTE 2 ACCOUNTING POLICIES

Revenue Recognition

North American Iron Ore

Revenue is recognized on the sale of products when title to the product has transferred to the customer in accordance with the specified provisions of each term supply agreement and all applicable criteria for revenue recognition have been satisfied. Most of our North American Iron Ore term supply agreements provide that title transfers to the customer when payment is received. Under some term supply agreements, we ship the product to ports on the lower Great Lakes and/or to the customer s facilities prior to the transfer of title. Certain supply agreements with one customer include provisions for supplemental revenue or refunds based on the customer s annual steel pricing at the time the product is consumed in the customer s blast furnaces. We account for this provision as a derivative instrument at the time of sale and record this provision at fair value until the product is consumed and the amounts are settled as an adjustment to revenue.

Revenue also includes reimbursement for freight charges and venture partners costs. The following table is a summary of reimbursements in our North American Iron Ore operations for the three and nine months ended September 30, 2008 and 2007:

	(In Millions) Three Months Ended September 30, 2008	2007	Nine Months Ended September 30, 2008	2007
Reimbursements for:				
Freight	$ 28.8	$ 23.7	$ 70.4	$ 57.0
Venture partners cost	37.2	51.3	143.4	150.3
Total reimbursements	$ 66.0	$ 75.0	$ 213.8	$ 207.3

North American Coal

We recognize revenue when title passes to the customer. For domestic coal sales, this generally occurs when coal is loaded into rail cars at the mine. For export coal sales, this generally occurs when coal is loaded into the vessels at the terminal. Revenue from product sales for the three and nine months ended September 30, 2008 included reimbursement for freight charges of $12.9 million and $34.6 million, respectively, compared with $2.2 million for the two months ended September 30, 2007.

Asia-Pacific Iron Ore

Sales revenue is recognized at the F.O.B. point, which is generally when the product is loaded into the vessel.

Deferred Revenue

As part of the agreement to acquire the remaining 30 percent interest in United Taconite, effective July 1, 2008, we committed approximately 1.2 million tons of iron ore pellets, which are to be provided from October 2008 through September 2009. This commitment represents an obligation to deliver the pellets as additional consideration for the remaining interest in United Taconite. The pellets are valued at $181.3 million, based upon the 2008 Eastern Canadian pellet price, and the additional consideration is recorded as *Deferred revenue* on the Statement of Condensed Consolidated Financial Position at September 30, 2008. This amount will be recognized as revenue upon shipment of the tons. The agreement also contains a penalty provision in the event the pellets are not delivered by a specified date. This provision is based in part on the Eastern Canadian pellet price and is characterized as an embedded derivative instrument. See NOTE 4 ACQUISITIONS & OTHER INVESTMENTS and NOTE 12 FAIR VALUE OF FINANCIAL INSTRUMENTS for further information.

In 2008, the terms of one of our North American Iron Ore pellet supply agreements require a prepayment by the customer for one estimated weekly shipment of pellets in addition to the amount of the bi-weekly invoice for shipments previously made. In 2007, the terms of the agreement required semi-monthly installments equaling 1/24th of the estimated total purchase value of the calendar-year nomination. In both years, revenue related to this supply agreement has been recognized when title transfers upon shipment of the pellets. Installment amounts received in excess of sales totaled $14.6 million, which were recorded as *Deferred revenue* on the Statements of Condensed Consolidated Financial Position at December 31, 2007. As of September 30, 2008 all revenue related to the supply agreement has been recognized.

Two of our North American Iron Ore customers purchased and paid for approximately 1.5 million tons of iron ore pellets in stockpiles in the fourth quarter of 2007. The customers requested the Company to not ship the iron ore pellets until the spring of 2008 under a fixed shipment schedule, when the Great Lakes waterways re-opened for shipping. Freight revenue related to these transactions of $13.8 million was deferred on the Statements of Condensed Consolidated Financial Position at December 31, 2007 and subsequently recognized in 2008 upon shipment. First and second quarter 2008 freight revenues included $5.3 million and $8.5 million, respectively, related to the shipment of 0.6 million and 0.9 million respective tons of pellets from the stockpiles.

Derivative Financial Instruments

Portman receives funds in United States currency for its iron ore sales. Portman uses forward exchange contracts, call options, collar options and convertible collar options to hedge its foreign currency exposure for a portion of its sales receipts. United States currency is converted to Australian dollars at the currency exchange rate in effect at the time of the transaction. The primary objective for the use of these instruments is to reduce exposure to changes in Australian and United States currency exchange rates and to protect against undue adverse movement in these exchange rates. Effective July 1, 2008, Portman has discontinued hedge accounting for these derivatives, but continues to hold these instruments as economic hedges to manage currency risk. At September 30, 2008, Portman had approximately $1.0 billion of outstanding exchange rate contracts in the form of call options, collar options, convertible collar options and forward exchange contracts with varying maturity dates ranging from October 2008 to August 2011. We had $3.2 million and $15.7 million of foreign currency hedge contracts recorded as *Derivative assets* on the September 30, 2008 and December 31, 2007 Statements of Condensed Consolidated Financial Position, respectively. We also had $1.0 million and $5.9 million of foreign currency hedge contracts recorded as non-current assets in *Deposits and miscellaneous* on the Statements of Condensed Consolidated Financial Position at September 30, 2008 and December 31, 2007, respectively. In addition, we had current and long-term currency hedge contracts of $36.6 and $13.3 million, respectively, which were classified as liabilities at September 30, 2008. The respective amounts were recorded as *Derivative liabilities* and *Other liabilities* on the Statement of Condensed Consolidated Financial Position at September 30, 2008.

Upon de-designation of these cash flow hedges, the instruments are prospectively marked to fair value each reporting period through *Changes in fair value of derivative instruments, net* on the Statements of Unaudited Condensed Consolidated Operations. For the third quarter and first nine months of 2008 the mark-to-market adjustments resulted in a net unrealized loss of $94.3 million, based on a spot rate of 0.80 at September 30, 2008. The amounts that were previously recorded as a component of *Other comprehensive income* are reclassified to earnings and a corresponding realized gain or loss is recognized upon settlement of the related contracts. For the three months ended September 30, 2008, we reclassified $12.4 million out of *Accumulated other comprehensive loss* related to contracts settled during the period, which was recorded as *Product revenues* on the Statements of Unaudited Condensed Consolidated Operations.

The purchase agreement for the acquisition of the remaining 30 percent interest in United Taconite contains a penalty provision in the event the 1.2 million tons of pellets, included as part of the purchase consideration, are not delivered by a specified date. This provision is characterized as an embedded derivative instrument and is based in part on the future Eastern Canadian pellet price. The instrument is marked to fair value each reporting period until the pellets are delivered and the amounts are settled. A derivative liability of $181.3 million, representing the fair value of the pellets, was recorded as *Deferred revenue* on the Statement of Condensed Consolidated Financial Position at September 30, 2008. See NOTE 12 FAIR VALUE OF FINANCIAL INSTRUMENTS for further information.

Certain supply agreements with one North American Iron Ore customer provide for supplemental revenue or refunds based on the customer s average annual steel pricing at the time the product is consumed in the customer s blast furnace. The supplemental pricing is characterized as an embedded derivative and is required to be accounted for separately from the base contract price. The embedded derivative instrument, which is finalized based on a future price, is marked to fair value as a revenue adjustment each reporting period until the pellets are consumed and the amounts are settled. We recognized $85.1 million and $26.1 million, in the third quarter of 2008 and 2007, respectively, and $195.4 million and $55.7 million for the nine months ended September 30, 2008 and 2007, respectively, as *Product revenues* on the Statements of Unaudited Condensed Consolidated Operations related to the supplemental payments. Derivative assets, representing the fair value of the pricing factors, were $137.0 million and $53.8 million, respectively, on the September 30, 2008 and December 31, 2007 Statements of Condensed Consolidated Financial Position.

Certain supply agreements primarily with our Asia-Pacific Iron Ore customers provide for revenue or refunds based on the ultimate settlement of annual international benchmark pricing provisions. The pricing provisions are characterized as freestanding derivatives and are required to be accounted for separately once iron ore is shipped. The derivative instrument, which is settled and billed once the annual international benchmark price is settled, is marked to fair value as a revenue adjustment each reporting period based upon the estimated forward settlement until the benchmark is actually settled. The derivative instrument was settled during the second quarter of 2008 upon settlement of annual international benchmark prices, and is therefore not reflected on the September 30, 2008 Statement of Condensed Consolidated Financial Position.

Effective October 19, 2007, we entered into a $100 million fixed interest rate swap to convert a portion of our floating rate debt to fixed rate debt. Interest on borrowings under our credit facility is based on a floating rate, dependent in part on the LIBOR rate, exposing us to the effects of interest rate changes. The objective of the hedge is to eliminate the variability of cash flows in interest payments for forecasted floating rate debt, attributable to changes in benchmark LIBOR interest rates. To support hedge accounting, we designate floating-to-fixed interest rate swaps as cash flow hedges of the variability of future cash flows at the inception of the swap contract. The amount charged to *Other comprehensive income* for the nine months ended September 30, 2008 was $0.4 million. *Derivative liabilities* of $1.8 million and $1.4 million were recorded on the Statements of Condensed Consolidated Financial Position as of September 30, 2008 and December 31, 2007, respectively. There was no ineffectiveness recorded for the interest rate swap in the first nine months of 2008.

<u>Inventories</u>

The following table presents the detail of our *Inventories* on the Statements of Condensed Consolidated Financial Position at September 30, 2008 and December 31, 2007:

Table of Contents

	(In Millions)					
	September 30, 2008			December 31, 2007		
Segment	Finished Goods	Work-in Process	Total Inventory	Finished Goods	Work-in Process	Total Inventory
North American Iron Ore	$ 176.5	$ 15.4	$ 191.9	$ 114.3	$ 16.5	$ 130.8
North American Coal	10.5	2.4	12.9	8.3	0.8	9.1
Asia-Pacific Iron Ore	29.2	79.9	109.1	30.2	71.8	102.0
Other	10.0	3.3	13.3	-	-	-
Total	$ 226.2	$ 101.0	$ 327.2	$ 152.8	$ 89.1	$ 241.9

The increase in inventory at September 30, 2008 is primarily due to increases within our North American Iron Ore segment primarily related to higher pellet stockpiles at Empire, as a result of an ongoing expansion project at the mine.

Income Taxes

Income taxes are based on income for financial reporting purposes calculated using our expected annual effective rate and reflect a current tax liability or asset for the estimated taxes payable or recoverable on the current year tax return and expected annual changes in deferred taxes. Any interest or penalties on income tax are recognized as a component of income tax expense.

We account for income taxes under the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial statements and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date.

We record net deferred tax assets to the extent we believe these assets will more likely than not be realized. In making such determination, we consider all available positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax planning strategies and recent financial results of operations. In the event we were to determine that we would be able to realize our deferred income tax assets in the future in excess of their net recorded amount, we would make an adjustment to the valuation allowance which would reduce the provision for income taxes. See NOTE 11 INCOME TAXES for further information.

Fair Value Measurements

Valuation Hierarchy

SFAS No. 157, *Fair Value Measurements* (SFAS 157) establishes a three-level valuation hierarchy for classification of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date.

Level 1 Valuation is based upon quoted prices (unadjusted) for identical assets or liabilities in active

markets.

Table of Contents

Level 2 Valuation is based upon quoted prices for similar assets and liabilities in active markets, or other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 Valuation is based upon other unobservable inputs that are significant to the fair value measurement.

The classification of assets and liabilities within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement in its entirety. Valuation methodologies used for assets and liabilities measured at fair value are as follows:

Cash Equivalents

Where quoted prices are available in an active market, cash equivalents are classified within Level 1 of the valuation hierarchy. Cash equivalents classified in Level 1 at September 30, 2008 include money market funds and variable rate demand notes. The valuation of these instruments is determined using a market approach and is based upon unadjusted quoted prices for identical assets in active markets. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flows. In these instances, the valuation is based upon quoted prices for similar assets and liabilities in active markets, or other inputs that are observable for substantially the full term of the financial instrument, and the related financial instrument is therefore classified within Level 2 of the valuation hierarchy. Level 2 securities include short-term investments such as commercial paper for which the value of each investment is a function of the purchase price, purchase yield, and maturity date.

Marketable Securities

Where quoted prices are available in an active market, marketable securities are classified within Level 1 of the valuation hierarchy. Marketable securities classified in Level 1 at September 30, 2008 include available-for-sale securities. The valuation of these instruments is determined using a market approach and is based upon unadjusted quoted prices for identical assets in active markets.

Derivative Financial Instruments

Derivative financial instruments valued using financial models that use as their basis readily observable market parameters are classified within Level 2 of the valuation hierarchy. Such derivative financial instruments include substantially all of our foreign currency exchange contracts and interest rate swap agreements. Derivative financial instruments that are valued based upon models with significant unobservable market parameters, and that are normally traded less actively, are classified within Level 3 of the valuation hierarchy.

Non-Financial Assets and Liabilities

We have deferred the adoption of SFAS 157 until January 1, 2009 with respect to non-financial assets and liabilities in accordance with the provisions of FSP FAS 157-2. Items that are recognized or disclosed at fair value for which we have not applied the provisions of SFAS 157 include goodwill, asset retirement obligations, guarantees and certain other items. See NOTE 12 FAIR VALUE OF FINANCIAL INSTRUMENTS for further information.

14

Table of Contents

Reclassifications

Certain amounts in the prior year consolidated financial statements have been reclassified to conform to the current year presentation. They included the reclassification of certain amounts included in *Miscellaneous net* to *Selling, general and administrative expenses* on the Statements of Unaudited Condensed Consolidated Operations.

Recent Accounting Pronouncements

In October 2008, the FASB issued FSP No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, which amends SFAS 157, by clarifying the application of the standard when the market for a financial asset is inactive. Specifically, the FSP clarifies how (1) management s internal assumptions should be considered in measuring fair value when observable data are not present, (2) observable market information from an inactive market should be taken into account, and (3) the use of broker quotes or pricing services should be considered in assessing the relevance of observable and unobservable data to measure fair value. This FSP was effective immediately upon its October 10, 2008 issuance and applies as well to prior periods for which financial statements have not yet been issued. Revisions resulting from a change in valuation technique are required to be accounted for as a change in estimate. This FSP was applied in our assessment of the fair values of our financial assets and liabilities accounted for under SFAS 157, but did not result in a material change to our fair value measurements or related disclosures at September 30, 2008.

In February 2008, the FASB issued FSP No. FAS 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13* (FSP 157-1). FSP 157-1 amends SFAS 157 to remove certain leasing transactions from its scope. In addition, on February 12, 2008, the FASB issued FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, which amends SFAS 157 by delaying its effective date by one year for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. This pronouncement was effective upon issuance. We have deferred the adoption of SFAS 157 with respect to all non-financial assets and liabilities in accordance with the provisions of this pronouncement. On January 1, 2009, SFAS 157 will be applied to all other fair value measurements for which the application was deferred under FSP FAS 157-2. We are currently assessing the impact SFAS 157 will have in relation to non-financial assets and liabilities on our consolidated financial statements. See NOTE 12 FAIR VALUE OF FINANCIAL INSTRUMENTS for further information.

In May 2008, the FASB issued FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (SFAS 162). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with U.S. GAAP. SFAS 162 is effective 60 days following the SEC s approval of the PCAOB s related amendments to remove the GAAP

hierarchy from auditing standards, where it has previously resided. We are evaluating the impact SFAS 162 will have on our consolidated financial statements upon adoption, but do not expect this Statement to result in a material change in current practice.

In April 2008, the FASB issued FSP No. FAS 142-3, *Determination of the Useful Life of Intangible Assets*. This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). The objective of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R), and other U.S. GAAP. This FSP applies to all intangible assets, whether acquired in a business combination or otherwise and shall be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years and applied prospectively to intangible assets acquired after the effective date. Early adoption is prohibited. We are currently evaluating the impact adoption of this FSP will have on our consolidated financial statements.

In March 2008, the FASB issued Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133,* (SFAS 161). This Statement amends and expands the disclosure requirements of SFAS 133 to provide users of financial statements with an enhanced understanding of how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations and how derivative instruments and related hedged items affect an entity s financial position, financial performance and cash flows. The new requirements apply to derivative instruments and non-derivative instruments that are designated and qualify as hedging instruments and related hedged items accounted for under SFAS 133. The Statement is effective for fiscal years and interim periods beginning after November 15, 2008. Early application is encouraged. We are currently evaluating the impact adoption of this Statement will have on our consolidated financial statements.

NOTE 3 MARKETABLE SECURITIES

During the second quarter of 2008, Portman acquired 22 million shares of Golden West, a Western Australia iron ore exploration company. Golden West owns the Wiluna West exploration ore project in Western Australia, containing a resource of 119 million metric tons of ore. The investment provides Portman a strategic interest in Golden West and Wiluna West. During the third quarter of 2008 we acquired approximately 2 million additional shares in Golden West, bringing our total number of shares held in Golden West to approximately 24 million shares. Our ownership in Golden West represents approximately 18.5 percent of its outstanding shares at September 30, 2008. Acquisition of the shares represents an investment of approximately $27 million. We do not exercise significant influence, and at September 30, 2008, the investment is classified as an available-for-sale security.

Our marketable securities are classified as either held-to-maturity or available-for-sale. We account for marketable securities in accordance with the provisions of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115). SFAS 115 addresses the accounting and reporting for investments in fixed maturity securities and for equity securities with

Table of Contents

readily determinable fair values. We determine the appropriate classification of debt and equity securities at the time of purchase and re-evaluate such designation as of each balance sheet date. In addition, we review our investments on an ongoing basis for indications of possible impairment. We review impairments in accordance with FSP SFAS 115-1 and 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, to determine the classification of the impairment as temporary or other-than-temporary. Once identified, the determination of whether the impairment is temporary or other-than-temporary requires significant judgment. The primary factors that we consider in classifying the impairment include the extent and time the fair value of each investment has been below cost. If a decline in fair value is judged other than temporary, the basis of the individual security is written down to fair value as a new cost basis, and the amount of the write-down is included as a realized loss. At September 30, 2008 and December 31, 2007, we had $68.6 million and $74.6 million, respectively, of marketable securities as follows:

	(In Millions)	
	September 30, 2008	December 31, 2007
Held to maturity - current	$ 5.8	$ 18.9
Held to maturity - non-current	16.8	25.8
	22.6	44.7
Available for sale - non-current	46.0	29.9
Total	$ 68.6	$ 74.6

Marketable securities classified as held-to-maturity are measured and stated at amortized cost. The amortized cost, gross unrealized gains and losses and fair value of investment securities held-to-maturity at September 30, 2008 and December 31, 2007 are summarized as follows:

	September 30, 2008 (In Millions)			
	Amortized	Gross Unrealized		Fair
	Cost	Gains	Losses	Value
Asset backed securities	$ 2.5	$ -	$ (0.6)	$ 1.9
Floating rate notes	20.1	-	(1.1)	19.0
Total	$ 22.6	$ -	$ (1.7)	$ 20.9

	December 31, 2007 (In Millions)			
	Amortized	Gross Unrealized		Fair
	Cost	Gains	Losses	Value
Asset backed securities	$ 23.1	$ -	$ (1.4)	$ 21.7
Floating rate notes	21.6	-	(0.1)	21.5
Total	$ 44.7	$ -	$ (1.5)	$ 43.2

Investment securities held-to-maturity at September 30, 2008 and December 31, 2007 have contractual maturities as follows:

17

Table of Contents

	(In Millions)	
	September 30, 2008	December 31, 2007
Asset backed securities:		
Within 1 year	$ -	$ 18.9
1 to 5 years	2.5	4.2
	$ 2.5	$ 23.1
Floating rate notes:		
Within 1 year	$ 5.8	$ -
1 to 5 years	14.3	21.6
	$ 20.1	$ 21.6

Marketable securities classified as available-for-sale are stated at fair value, with unrealized holding gains and losses included in *Other comprehensive income*. The amortized cost, gross unrealized gains and losses and fair value of investment securities available-for-sale at September 30, 2008 and December 31, 2007 are summarized as follows:

	(In Millions) September 30, 2008			
	Amortized	Gross Unrealized		Fair
	Cost	Gains	Losses	Value
Equity securities (without contractual maturity)	$ 41.8	$ 6.1	$ (1.9)	$ 46.0

	(In Millions) December 31, 2007			
	Amortized	Gross Unrealized		Fair
	Cost	Gains	Losses	Value
Equity securities (without contractual maturity)	$ 14.2	$ 15.7	$ -	$ 29.9

NOTE 4 ACQUISITIONS & OTHER INVESTMENTS

In accordance with FASB Statement No. 141, *Business Combinations* (SFAS 141), we allocate the cost of acquisitions to the assets acquired and liabilities assumed based on their estimated fair values. The excess of the cost over the fair value of the net assets acquired is recorded as goodwill.

United Taconite

On July 11, 2008 we acquired the remaining 30 percent interest in United Taconite, with an effective date of July 1, 2008. Upon consummation of the purchase, our ownership interest increased from 70 percent to 100 percent. The acquisition of the remaining minority interest was completed in order to strengthen our core North American Iron Ore business. The consolidation of the United Taconite minority interest, together with our Northshore property, represents two wholly-owned iron ore subsidiaries in North America.

The aggregate acquisition price for the remaining interest in United Taconite was approximately $450.7 million, which included cash in the amount of $104.4 million, approximately 1.5 million of our

18

Table of Contents

common shares valued at $165 million, and approximately 1.2 million tons of iron ore pellets, valued at $181.3 million, to be provided throughout 2008 and 2009. The value of the stock was determined based on the July 10, 2008 closing price of $107.87 per share. The value of the iron ore pellets was determined based on estimated iron units of 65 percent at the 2008 Eastern Canadian pellet price of approximately $2.33 per iron unit. In October 2008, we issued an additional 2.8 million shares to satisfy a below-market guarantee provision specified within the agreement.

The purchase agreement included a provision which gives the seller the right to put the common shares back to us for $165 million of cash if the shares are not registered by a specified date. As a result of this provision, a current liability of $165 million was recorded as *Unregistered common shares issued* on the Statement of Condensed Consolidated Financial Position as of September 30, 2008. The amount will be reclassified to *Shareholders Equity* upon registration of the shares. See NOTE 19 SUBSEQUENT EVENTS for further information.

The Statement of Condensed Consolidated Financial Position as of September 30, 2008 reflects the acquisition of the remaining interest in United Taconite, effective July 1, 2008, under the purchase method of accounting. The transaction constituted a step acquisition of a non-controlling interest. As of the date of the step acquisition of the minority interest, the then historical cost basis of the minority interest balance was eliminated, and the increased ownership obtained was accounted for by increasing United Taconite s basis from historical cost to fair value for the portion of the assets acquired and liabilities assumed based on the 30 percent additional ownership acquired.

We are in the process of conducting a valuation of the assets acquired and liabilities assumed related to the acquisition, most notably, property, plant and equipment, mineral reserves, and sales contracts, and the final allocation will be made when completed. Accordingly, allocation of the purchase price is preliminary and subject to modification in the future. The following represents the preliminary allocation of the aggregate purchase price as of September 30, 2008:

	(In Millions)
Purchase price	$ 450.7
Carrying value of net assets acquired	$ 25.3
Fair value adjustments:	
ASSETS	
Land	7.5
Plant and equipment	80.4
Mineral reserves	491.0
Intangible assets	75.4
LIABILITIES	
Below market sales contracts	(228.9)
Fair value of net assets acquired	$ 450.7

The intangible assets acquired include $72.3 million and $3.1 million of permits and leases, respectively. See NOTE 5 GOODWILL AND OTHER INTANGIBLE ASSETS for further information.

19

Portman Share Repurchase

On May 21, 2008, Portman authorized a tender offer to repurchase up to 16.5 million shares, or 9.39 percent of its common stock. On this date, we owned 80.4 percent of the approximately 176 million shares outstanding in Portman and indicated we would not participate in the tender buyback. The tender period closed on June 24, 2008. Under the buyback, 9.8 million fully paid ordinary shares were tendered at a price of $14.10 (A$14.66) per share. The total consideration paid under the buyback was $137.8 million (A$143.3 million), with our share totaling $110.8 million (A$115.2 million) based on our ownership percentage at the time. As a result of the buyback, our ownership interest in Portman increased from 80.4 percent to 85.2 percent. See NOTE 19 SUBSEQUENT EVENTS for further information.

The transaction constituted a step acquisition of a non-controlling interest. In accordance with SFAS 141, we have accounted for the acquisition of the minority interest in Portman by the purchase method. As a result of the step acquisition, the then historical cost basis of the minority interest balance was reduced to the extent of the percentage interest sold, or $49.0 million, and the increased ownership obtained was accounted for by increasing Portman s basis from historical cost to fair value for the portion of the assets acquired and liabilities assumed based on the 4.75 percent additional ownership acquired.

We are in the process of conducting a valuation of the assets acquired and liabilities assumed related to the acquisition, most notably, inventory, mineral reserves and plant and equipment, and the final allocation will be made when completed. Accordingly, allocation of the purchase price is preliminary and subject to modification in the future. The following represents the preliminary allocation of the aggregate purchase price as of the date of acquisition:

	(In Millions)
Carrying value of net assets acquired	$ 21.9
Fair value adjustments:	
ASSETS	
Inventory	27.9
Plant and equipment	6.8
Mineral reserves	58.9
Intangible assets	17.5
LIABILITIES	
Deferred taxes	(33.4)
Fair value of net assets acquired	99.6
Goodwill	11.2
Purchase price	$ 110.8

Based on management s preliminary allocation of the acquisition cost to the fair value of the net assets acquired, approximately $11.2 million was assigned to goodwill as of the date of acquisition. See NOTE 5 GOODWILL AND OTHER INTANGIBLE ASSETS for further information.

In order to enable us to move to full ownership of Portman, on September 10, 2008, we announced an off-market takeover offer to acquire, through our wholly-owned subsidiary, Cliffs Asia-Pacific Pty Limited, all

of the shares in Portman that we do not already own. The offer is a last and final cash offer at a price of $17.65 (A$21.50) per Portman share. Refer to NOTE 19 SUBSEQUENT EVENTS for further information.

Table of Contents

PinnOak

The Statement of Unaudited Condensed Consolidated Financial Position of the Company as of September 30, 2008 reflects the acquisition of PinnOak, effective July 31, 2007, under the purchase method of accounting. The total cost of the acquisition has been allocated to the assets acquired and the liabilities assumed based upon their estimated fair values at the date of the acquisition. The allocation resulted in an excess of fair value of acquired net assets over cost. As the acquisition involved a contingent earn-out, a liability has been recorded totaling $178.5 million, representing the lesser of the maximum amount of contingent consideration or the excess prior to the pro rata allocation of purchase price. We finalized the purchase price allocation in the second quarter of 2008. A comparison of the finalized purchase price allocation to the initial allocation is as follows:

	(In Millions)		
	Finalized Allocation	Initial Allocation	Change
ASSETS			
Current assets	$ 80.8	$ 77.2	$ 3.6
Property, plant and equipment	156.7	133.0	23.7
Mineral rights	676.5	619.9	56.6
Asset held for sale	14.0	-	14.0
Other assets	3.7	3.6	0.1
Total assets	$ 931.7	$ 833.7	$ 98.0
LIABILITIES			
Current liabilities	$ 62.5	$ 61.3	$ 1.2
Long-term liabilities	268.0	171.2	96.8
Total liabilities	330.5	232.5	98.0
Purchase price	$ 601.2	$ 601.2	$ -

The adjustment since our initial allocation reduced coal inventory by $1.1 million to reflect inventory survey adjustments, increased supplies inventory by $4.8 million to reflect the capitalization of supplies inventory, increased property, plant and equipment by $23.7 million and increased mineral rights by $56.6 million to reflect market-based valuation adjustments. The asset held for sale represents the estimated fair value less cost to sell of the assets of a pond fines recovery operation. The sale was completed on February 15, 2008. The increase in current liabilities reflects additional accruals for non-income taxes. The increase in long-term liabilities represents adjustments to the contingent earn-out, $78.5 million, and an increase in deferred tax liabilities resulting from further assessment of the purchase price for tax purposes, $18.0 million.

Under the initial purchase agreement for PinnOak, a portion of the purchase price was deferred until December 31, 2009. The Statement of Unaudited Condensed Consolidated Financial Position reflects the deferred payment of $100.6 million within *Amounts due to former owners of PinnOak* at September 30, 2008. The purchase agreement also included the aforementioned contingent earn-out, which ranged from $0 to $300 million dependent upon PinnOak s operational and financial performance in 2008 and 2009. In October 2008, we entered into an agreement to accelerate the payment of the deferred portion of the

purchase price and settle the contingent earn-out. See NOTE 19 SUBSEQUENT EVENTS for further information.

Table of Contents

Alpha Natural Resources

On July 16, 2008, we announced the entry into a definitive merger agreement with Alpha Natural Resources, Inc. under which we will acquire all outstanding shares of Alpha in a cash and stock transaction. Under the terms of the agreement, for each share of Alpha common stock, Alpha stockholders would receive 0.95 of our common shares and $22.23 in cash. The aggregate consideration comprises approximately $1.7 billion in cash and approximately 70 million new common shares. JPMorgan Chase Bank, N.A. is providing an underwriting commitment for up to approximately $1.7 billion which will be used to finance the majority of the cash portion of the transaction. See NOTE 19 SUBSEQUENT EVENTS for further information.

The combined company would become one of the largest U.S. mining companies and be positioned as a leading diversified mining and natural resources company. The combined company s significant position in both iron ore and metallurgical coal will make it a major supplier to the global steel industry, as well as provide a platform for further diversification both geographically and in terms of the mineral and resource products it sells.

The transaction is subject to shareholder approval as well as the satisfaction of customary closing conditions and regulatory approvals. On August 22, 2008, early termination of the waiting period under the Hart-Scott-Rodino Act was granted by the Federal Trade Commission. The special shareholder vote to approve the merger agreement and approve the issuance of our common shares in connection with the merger is currently scheduled for November 21, 2008, and the proposed merger is expected to close as soon as practical after the respective special meetings of Alpha s stockholders and our shareholders, provided all other conditions have been satisfied or waived.

The merger agreement contains certain termination rights for both parties. Specifically, if we terminate the agreement because Alpha s Board of Directors withdraws its recommendation of the deal, or Alpha terminates to accept an alternative transaction, or if the merger agreement is terminated and Alpha enters into or consummates another transaction within one year of such termination, then Alpha will have to pay us a $350 million termination fee. Similarly, if Alpha terminates the agreement because our Board of Directors withdraws its recommendation of the deal, or if the agreement is terminated and we enter into or consummate another transaction within one year of such termination, then we will have to pay Alpha a $350 million termination fee. In addition, if Alpha s stockholders do not approve the transaction, Alpha will have to pay us a $100 million termination fee, and if our shareholders do not approve the transaction, we will have to pay Alpha a $100 million termination fee.

NOTE 5 GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill

The following table summarizes changes in the carrying amount of goodwill during the nine months ended September 30, 2008:

	(In Millions)
Balance at January 1, 2008	$ 11.8
Arising in 2008 business combinations	11.2
Impact of foreign currency translation	(1.7)
Balance at September 30, 2008	$ 21.3

Goodwill is not subject to amortization and is tested for impairment annually during the fourth quarter, or when events or circumstances indicate that impairment may have occurred.

Other Intangible Assets

Following is a summary of other intangible assets at September 30, 2008, based upon our preliminary purchase price allocations related to recent acquisitions:

			(In Millions)	
	Classification	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Definite lived intangible assets:				
Permits	*Intangible assets*	$ 89.8	$ (0.9)	$ 88.9
Leases	*Intangible assets*	3.1	(0.5)	2.6
Total intangible assets		$ 92.9	$ (1.4)	$ 91.5
Below market sales contracts	*Other long-term liabilities*	$ (228.9)	$ 7.6	$ (221.3)

The intangible assets are subject to periodic amortization over their estimated useful lives. Permits are being amortized over estimated useful lives ranging from 15 to 28 years, and leases are being amortized over estimated useful lives ranging from 1.5 to 4.5 years. The below-market sales contracts are classified as a liability and accreted over the terms of the contracts, which range from 3.5 to 8.5 years. Intangible assets subject to amortization are reviewed for potential impairment whenever events or circumstances indicate that carrying amounts may not be recoverable.

NOTE 6 DEBT AND CREDIT FACILITIES

On June 25, 2008, we entered into a $325 million private placement consisting of $270 million of 6.31 percent Five-Year Senior Notes due June 15, 2013, and $55 million of 6.59 percent Seven-Year Senior Notes due June 15, 2015. Interest will be paid on the notes for both tranches on June 15 and December 15 until their respective maturities. The notes are unsecured obligations with interest and principal amounts guaranteed by certain of our domestic subsidiaries. The notes and guarantees were not required to be registered under the Securities Act of 1933, as amended, and were placed with qualified institutional investors. We used the proceeds to repay senior unsecured indebtedness and for general corporate purposes.

The terms of the note purchase agreement contain customary covenants that require compliance with certain financial covenants based on: (1) debt to earnings ratio and (2) interest coverage ratio. As of September 30, 2008, we were in compliance with the covenants in the note purchase agreement.

On August 17, 2007, we entered into a five-year unsecured credit facility with a syndicate of 13 financial institutions. The facility provides $800 million in borrowing capacity, comprised of $200

million in term loans and $600 million in revolving loans, swing loans and letters of credit. Loans are drawn with a choice of interest rates and maturities, subject to the terms of the agreement. Interest rates are either (1) a range from LIBOR plus 0.45 percent to LIBOR plus 1.125 percent based on debt and earning levels or (2) the prime rate or the prime rate plus 1.125 percent, based on debt and earnings.

The credit facility has two financial covenants based on: (1) debt to earnings ratio and (2) interest coverage ratio. As of September 30, 2008, we were in compliance with the covenants in the credit agreement.

As of September 30, 2008, no revolving loans were drawn under the credit facility and the principal amount of letter of credit obligations totaled $19.4 million. We had $200 million drawn in term loans; $580.6 million of borrowing capacity was available under the $800 million credit facility. The weighted average annual interest rate for outstanding revolving and term loans under the credit facility was 3.3 percent as of September 30, 2008. After the effect of interest rate hedging, the weighted average annual borrowing rate was 4.3 percent.

Portman has a A$40 million multi-option facility, under which a A$120 million cash facility was added effective June 23, 2008, and terminated on September 30, 2008. The A$40 million multi-option facility has floating interest rates of 20 basis points and 75 basis points, respectively, over the 90-day bank bill swap rate in Australia. At September 30, 2008, the outstanding bank commitments totaled A$28.9 million in performance bonds, reducing borrowing capacity to A$11.1 million. The facility agreement contains financial covenants as follows: (1) debt to earnings ratio and (2) interest coverage ratio. As of September 30, 2008, Portman was in compliance with the financial covenants of the credit facility agreement.

In 2005, Portman secured five-year financing from its customers in China as part of its long-term sales agreements to assist with the funding of the expansion of its Koolyanobbing mining operations. The borrowings, totaling $5.6 million and $6.2 million at September 30, 2008 and December 31, 2007, respectively, accrue interest annually at five percent. The borrowings require a principal payment of approximately $0.8 million plus accrued interest to be made January 31, 2009, with the balance due in full on January 31, 2010.

At September 30, 2008, Amapá had long-term project debt outstanding of approximately $299 million for which we have provided a several guarantee on our 30 percent share. Amapá and its lenders have agreed to suspend all operating and financial loan covenants with the exception of debt to equity ratio requirements through June 30, 2009. In addition, at September 30, 2008, Amapá had total short-term loans outstanding of $210.3 million for which we provided a several guarantee on our share. On September 30, 2008, we have provided several guarantees on our 30 percent share of the total debt outstanding, or $152.8 million.

NOTE 7 SEGMENT REPORTING

Our company is organized and managed according to product category and geographic location: North American Iron Ore, North American Coal, Asia-Pacific Iron Ore, Asia-Pacific Coal and Latin American Iron Ore. The North American Iron Ore segment is comprised of our interests in six North American mines that provide iron ore to the integrated steel industry. The North American Coal

segment is comprised of our three North American coal mines that provide metallurgical coal to the integrated steel industry. The Asia-Pacific Iron Ore segment, comprised of our interests in Portman, is located in Western Australia and provides iron ore to steel producers in China and Japan. There are no intersegment revenues.

The Asia-Pacific Coal operating segment is comprised of our 45 percent economic interest in Sonoma, located in Queensland, Australia, which is in the early stages of production. The Latin American Iron Ore operating segment is comprised of our 30 percent Amapá interest in Brazil, which is also in the early stages of production. As a result, the Asia-Pacific Coal and Latin American Iron Ore operating segments do not meet reportable segment disclosure requirements and therefore are not separately reported.

We evaluate segment performance based on sales margin, defined as revenues less cost of goods sold identifiable to each segment. This measure of operating performance is an effective measurement as we focus on reducing production costs throughout the Company.

The following table presents a summary of our reportable segments for the three and nine months ended September 30, 2008 and 2007:

Table of Contents

	(In Millions) Three Months Ended September 30,				(In Millions) Nine Months Ended September 30,			
	2008		2007		2008		2007	
Revenues from product sales and services:								
North American Iron Ore	$ 811.3	68%	$ 469.9	76%	$ 1,733.5	64%	$ 1,127.9	76%
North American Coal	102.6	9%	33.9	5%	258.0	10%	33.9	2%
Asia-Pacific Iron Ore	232.7	19%	115.8	19%	618.4	23%	330.9	22%
Other	43.1	4%	-		82.9	3%	-	
Total revenues from product sales and services for reportable segments	$ 1,189.7	100%	$ 619.6	100%	$ 2,692.8	100%	$ 1,492.7	100%
Sales margin:								
North American Iron Ore	$ 259.3		$ 101.9		$ 596.5		$ 243.6	
North American Coal	(13.3)		(15.9)		(38.8)		(15.9)	
Asia-Pacific Iron Ore	99.7		21.3		282.0		71.0	
Other	19.3		-		34.1		-	
Sales margin	365.0		107.3		873.8		298.7	
Other operating expense	(25.6)		(25.4)		(82.2)		(56.0)	
Other income (expense)	(95.8)		(2.2)		(100.8)		6.2	
Income from continuing operations before income taxes, minority interest and equity loss from ventures	$ 243.6		$ 79.7		$ 690.8		$ 248.9	
Depreciation, depletion and amortization:								
North American Iron Ore	$ 17.5		$ 10.2		$ 38.4		$ 30.0	
North American Coal	12.2		5.7		39.8		5.7	
Asia-Pacific Iron Ore	17.5		12.8		44.5		35.4	
Other	3.9		-		6.5		-	
Total depreciation and amortization	$ 51.1		$ 28.7		$ 129.2		$ 71.1	
Capital additions (1):								
North American Iron Ore	$ 30.2		$ 13.1		$ 49.7		$ 54.3	
North American Coal	36.3		4.3		56.2		4.3	
Asia-Pacific Iron Ore	16.5		9.6		51.7		12.6	
Other	3.5		-		14.8		-	
Total capital additions	$ 86.5		$ 27.0		$ 172.4		$ 71.2	

(1) Includes capital lease additions.

A summary of assets by segment is as follows:

	(In Millions)	
	September 30, 2008	December 31, 2007
Segment assets:		
North American Iron Ore	$ 1,900.5	$ 968.9
North American Coal	872.8	773.2
Asia-Pacific Iron Ore	1,107.1	1,083.8
Other	428.8	249.9
Total assets	$ 4,309.2	$ 3,075.8

Table of Contents

NOTE 8 COMPREHENSIVE INCOME

The following are the components of comprehensive income for the three and nine months ended September 30, 2008 and 2007:

	(In Millions)			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net Income	$ 174.9	$ 56.9	$ 461.9	$ 176.3
Other comprehensive (loss) income:				
Unrealized net (loss) gain on marketable securities - net of tax	(19.4)	0.3	(7.7)	3.6
Foreign currency translation	(125.1)	28.1		