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What does the United States Securities and Exchange Commission (SEC) expect in a 10-K Reserves filing?

First, Some Recommended Definitions

- *Reserves Report*
  - Typically a “grass roots” report prepared by a qualified person(s) in full compliance with the relevant reserves definitions.
  - Includes projections of production, revenues, costs (Capex,Opex,Taxes, Abandonment [net of salvage]) and future net income discounted at 10%.
  - May be prepared by respondent or third party engineering firm(s).

More Recommended Definitions

- *Reserves Audit*
  - Typically an examination of client reserves report for the purpose of expressing an opinion. May audit reserves and/or values.
  - Work product usually confined to letter report expressing opinion.
  - Tolerances within ±10 percent.
  - May involve 70-90% of value.
  - Underlying report must be of high quality and correct.
  - Audit is a test of reserves classifications (Proved, Probable, Possible).
  - Does not test economic assumptions.

Even More Recommended Definitions

- *Reserves Review*
  - An independent analysis of the processes and procedures underlying a reserves report.
  - May address qualifications of preparers, adequacy and timeliness of data and other considerations.
  - Review may have little effect on numerical quality of subsequent reserves reports.

What is a SEC “compliant report”?

- An estimate of the reserves and future revenues using “existing economic and operating conditions” (12/31 prices and costs).
- Recoverable from “known reservoirs” to a level of “reasonable certainty”.
- Revenues limited to that from sale of produced hydrocarbons and not associated income from sulphur, CO2, processing fees, platform rentals, etc.
- Limited reliance upon 3-D seismic and other new technology.

How does SEC assure that companies are in compliance?

- In recent years, the engineering staff issues “comment letters” initially asking generic type questions about many issues, including PUDs, pricing, reliance upon third-party firms, reserves-linked performances bonuses, recovery factors and other matters.

How does SEC assure that companies are in compliance?

- Upon producer response, SEC then narrows remaining relevant questions to specific properties and may ask for maps and other supporting documentation.

- May result in iteration of several letters back and forth until SEC is satisfied or asks producer to make modifications

Significant Revisions Requested by SEC

- *De-booking*
  - Typically results from SEC request to remove certain reserves from the next annual reserves filing.
  - May be selected undeveloped reserves, reserves below a lowest-known contact, improved recovery reserves or incremental reserves in excess of a "proved" recovery efficiency.

Significant Revisions Requested by SEC

- *Restatement*
  - A much more serious consequence than de-booking in that certain previous filings must be corrected to remove reporting errors.
  - May carry severe penalties under Sarbanes-Oxley Act of 2002 (SOX).

SEC Definitions

- Promulgated in 1978 - have not been changed since that time.
- Clarified by periodic Staff Accounting Bulletins (STABS) and 2001 website release.
- Conservatively interpreted by SEC engineers joining staff in 1999.
- Ryder Scott has modified its SEC report criteria for clients in several regards since 1999.
- Industry disappointed at staff reluctance to allow more reliance on current technology, much of which was not even conceived in 1978.

Conclusions

- Reserves report preparers must make diligent efforts to remain independent of undue influence by management or clients if consultant and take whatever steps necessary to become aware of SEC definitions and reporting requirements.
- WARNING – becoming too conservative in attempt to escape SEC criticism may result in under-reporting of reserves which then violates the “Full Disclosure “ provisions of the SEC reporting mandate.

(More Follows)

20 QUESTIONS ...

… that should be asked to help assess the degree of reserve risk associated with a company’s reserves.

1.

Who did the underlying reserves evaluation?

Internal engineering
or
independent consulting firm ?

2.

Is the independent consulting firm or company engineering staff knowledgeable of SEC reserve definitions and the appropriate reporting requirements ?

3.

How long has the independent consulting firm been doing the company's reserves ?

Is the engineering firm familiar with special issues that might be involved with the company's properties ?

4.

Where are the reserves located ?

How knowledgeable is the company of the areas where the reserves are located ?

Are they in an area where assessment of reserves carries greater risk
(i.e. Gulf Coast vs. Mid-Continent) ?

Are the reserves concentrated in specific areas, or are they widely scattered
(i.e. do they have core areas of competency) ?

Are the reserves in areas that require higher operating and development costs
(i.e. profit margin is smaller and expenditure demands are higher on the company) ?

Are the reserves in areas that are environmentally very sensitive ?

Are the reserves all domestic,
or do they include international properties ?

5.

Is the independent consulting firm familiar with the areas where the reserves are located?

6.

Does the independent consulting firm look at all of the company reserves or just a percentage ?

Does the consulting firm do a detailed study or an audit ?

7.

Are the company’s reserves concentrated in a small number of properties, or is the portfolio of properties more diverse ?

What type of interest position does the company hold in its different properties ?

8.

Are the reserves mature, or relatively new with minimal production ?

Is the reserve analysis primarily based on performance methods or volumetrics ?

Are the reserves strictly primary, or do they include secondary and EOR projects ?

9.

Are most of the properties operated or non-operated ?

If a high percentage of the company's reserves are non-operated, what is known about the operators ?

Are the various operators substantial from a technical and business standpoint ?

Do the operators have an established track record of operations in the areas where the reserves are located ?

10.

What is the distribution of proved reserve status categories (i.e. producing, shut-in, behind pipe and undeveloped) ?

Are the reserves fairly well split between categories, or is there a high percentage in the non-producing and particularly in the undeveloped ?

11.

What is the RIP ratio for proved producing reserves ?

Is this realistic for the type of proved producing reserves stated in the SEC filing ?

Is this realistic taking into account the current production of the company ?

12.

What is the RIP ratio for total proved reserves ?

What level of producing rates will have to be added by non-producing and undeveloped reserves to make a reasonable life index ?

Does this seem attainable for the types of reserves involved ?

13.

Are the reported reserves based on the appropriate economic parameters as specified by the Securities and Exchange Commission ?

Did the reserve appraiser use current economic conditions ?

14.

Do future revenue projections appear reasonable considering recent historical company revenues ?

15.

Do future cost projections appear reasonable considering recent historical company expenditures ?

Have the appropriate operating costs been applied against the reserve projections ?

Does the company have sufficient cashflow to carry their burden of operating costs and service other necessary company expenditures ?

Have sufficient development costs been included to develop the stated non-producing and undeveloped reserves ?

Does the company have an established track record and the financial stability to spend the amounts of capital dollars necessary to fund the development ?

16.

How does the company compare over time in regard to “revisions of previous estimates” ?

Have the revisions consistently been significant
in size in relation to the company’s base reserves ?

Are the revisions consistently negative ?

Are the negative revisions consistently associated
with the non-producing and undeveloped
reserve categories ?

17.

“Extensions, discoveries, other additions” are an indicator of how well the company is moving proved undeveloped and probable reserves into the developed reserve base of the company. Is the company historically demonstrating an ability to do so ?

How well is the company finding new reserves through the drill bit ?

Does the company have an active exploration and development drilling program ?

Does the company have a good acreage position around its developing properties ?

What kind of exploratory acreage position does the company hold ?

18.

Does the company typically grow through acquisitions or the drill bit ?
Is there a good mix of both ?

Does “purchase of reserves in place” contribute significantly to the company’s reserve base ?

If the company traditionally grows through acquisitions, is the company paying an appropriate amount for reserves ?

Could too much success with competitive bids mean they are over-paying for the reserves ?

19.

Does the company "sell reserves in place" to divest themselves of non-strategic reserves ?

Is the company burdened with a large number of low margin wells in non-core areas ?

20.

How recent is the reserve evaluation that is the source of the company's reserves in the public filing ?

Based on the answers to some of the previous questions, are the reserves of a nature that significant changes in reserve quantities can occur over a limited period of time ?

Is the reserve evaluation a recent study or a prior study that has been mechanically adjusted to a specific as-of date for public reporting purposes ?