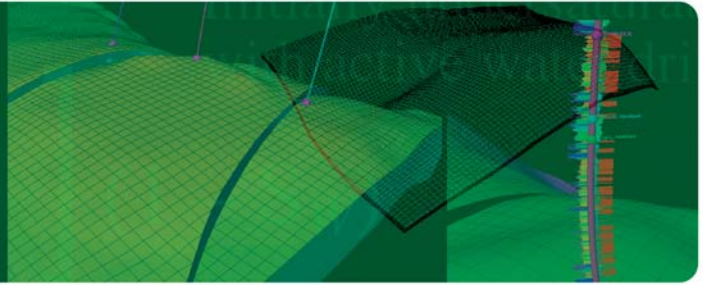


RESERVOIR SOLUTIONS



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High F&D costs, low cash returns in U.S., says Oram



Andrew Oram

All-time-high finding-and-development costs last year caused cash returns to plummet for U.S. producers despite high commodity prices, said **Andrew Oram**, vice president and senior credit officer at Moody's Investors Service. He spoke at the Third Annual Ryder Scott Reserves Conference in Houston on May 4. Pointing to drillbit costs that more than doubled for Moody's high-credit-risk, B-rated companies,

Oram said, "This is unheard of. That is why cash returns plummeted," said Oram. "I don't expect much improvement from last year. This has not been a good year for cash in, cash out."

High F&D and acquisition costs negatively affected both investment- and medium-grade companies last year. Although improved technology has commercialized plays, it has also caused steep declines in increasingly smaller fields.

During 2006-07, more E&Ps lacked properties for reinvestment while stock buybacks and capital expenditures exceeded cash flow and new equity—all ingredients for a credit cycle that peaked for the first time during a high-price environment, Oram said. He cited

the deepwater Gulf of Mexico lower tertiary deposits, unconventional resource plays and oil sands as sources of potential growth but with high price tags.

"I have heard people say, 'Looks like a good prospect. Too bad we have to drill it.'" — Oram

In addressing whether producers reporting to the U.S. Securities and Exchange Commission are undervalued compared to producers in other market regimes, Oram said, "It hasn't hurt Exxon," adding that the E&P sector "has had 147 years to perfect the art of raising capital on something that no one will ever see

Please see Conference on Page 2

Shift from Houston as tech center not healthy, says UH's Daneshy



Ali Daneshy, director of the petroleum engineering program at the University of Houston, said that Halliburton's announcement in March of its planned move to Dubai signals a further shift from Houston as the technology center of the oil industry. "This is not healthy for industry because the culture will change," he remarked, saying that 70 percent of daily judgments are culturally based and 30 percent are based on technological knowledge.

The U.S. culture has proved to be a fertile proving ground for the petroleum industry, fostering empowerment and decision making at the lowest level, actively engaging young professionals, emphasizing operational technical skills over theoretical ones and nurturing an

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and too few deeply understand.”

He said that the value of reserves additions is already in the share price on news on the discovery. The booking is just a validation of old news. The market also sifts through rhetoric on evolving plays and management’s past credibility. “I have heard people say, ‘Looks like a good prospect. Too bad we have to drill it,’” Oram remarked.

He said that the use of large, recognized third-party reserves evaluation consultants provides comfort to market investors. “There is a difference in the (reserves) numbers for a large consultant vs. a small consultant, especially a small consultant with a large customer,” Oram said.

He mapped an average large-cap E&P company for credit-rating analyses, showing the weighted value of reserves or reserves-related components, which included production, proved developed reserves, total proved reserves, portfolio diversification, F&D costs and full-cycle costs per barrel of oil equivalent.



Ali Daneshy

“They (new graduates) need cultural-based training.”—Daneshy

He said that the two main sources for petroleum engineering graduates will be India and China. At the same time, U.S. universities are not graduating enough engineers to take care of future needs. Daneshy cited an 80-percent drop in the number of petroleum engineering graduates over the last two decades.

Even with fewer students, universities still have a severe shortage of faculty inhibiting their growth. Compensation offered by companies has exploded the last two years, attracting academics to the private sector.

Daneshy said that UH is in a unique position to abate the shift from Houston and the U.S., citing among other factors, the university’s location and access to the best technical minds in the industry to teach and collaborate. UH is raising funds to support a planned undergraduate petroleum engineering program. The university currently offers post-graduate programs in petroleum engineering.

Daneshy—Cont. from Page 1

entrepreneurial, competitive spirit. In contrast, Daneshy said that Beijing has issued a directive, based on China’s population, for the country to graduate 600,000 engineers annually. “The training is limited to text books. They need cultural-based training,” he remarked. “Also the training should be based on industry needs. China does not have an industrial base as big as the U.S.”

Publisher’s Statement

Reservoir Solutions newsletter is published quarterly by Ryder Scott Company LP. Established in 1937, the reservoir evaluation consulting firm performs hundreds of studies a year. Ryder Scott multidisciplinary studies incorporate geophysics, petrophysics, geology, petroleum engineering, reservoir simulation and economics. With 115 employees, including 72 engineers and geoscientists, Ryder Scott has the capability to complete the largest, most complex reservoir-evaluation projects in a timely manner.

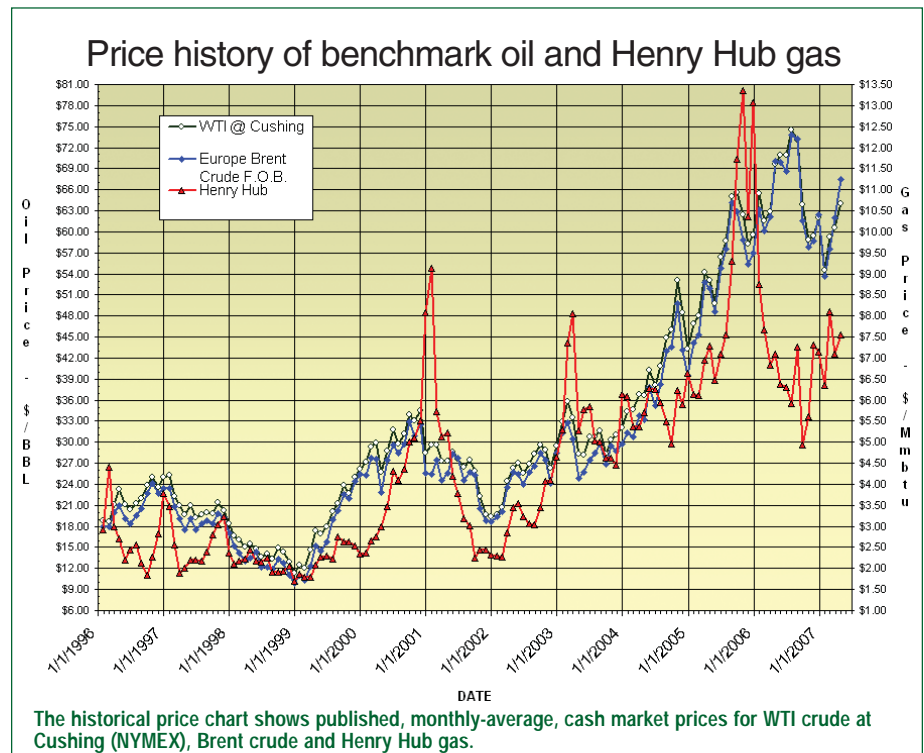
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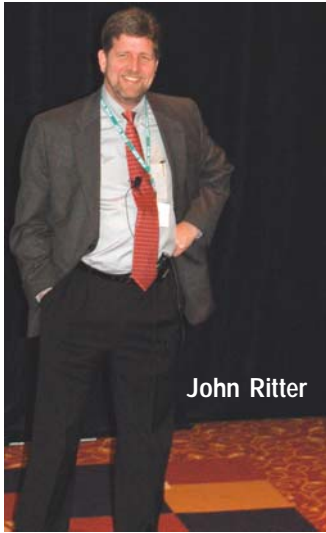
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The historical price chart shows published, monthly-average, cash market prices for WTI crude at Cushing (NYMEX), Brent crude and Henry Hub gas.

New reserves guidelines presented by OGRC chairman



John Ritter

Contingent resources, considered less certain than reserves, have gained some respect with new industry-sanctioned categories approved in late March. **John Ritter**, chairman of the SPE Oil & Gas Reserves Committee, presented the new categories as part of his presentation on the new jointly adopted Petroleum Resources Management System at the Ryder Scott Reserves Conference in May.

Contingent resources are now defined by the following criteria:

- Uncertainty categories—1C, 2C and 3C—align with the 1P, 2P and 3P reserves categories.
- Subclassified by three commerciality criteria—development not viable, development unclarified or on hold and development pending.
- Marginal contingent resources are projected to be economic; submarginal are projected to be uneconomic.

conomic.

The revisions in the PRMS help resolve ambiguities between reserves and contingent resources classifications at specific project maturity stages. If development is pending, for instance because of a lack of infrastructure or environmental concerns, then the hydrocarbon quantity is subcommercial and a contingent resource.

If the company has justified development of the field, then the quantity is commercial and can be classified as reserves. The chart shown by Ritter also indicated that quantities can be reserves before final approval of development, which does not agree with some interpretations from the U.S. Securities and Exchange Commission. However, the project-based PRMS is aligned with companies' internal evaluations of commerciality, not SEC compliance.

Ritter said that the OGRC recommended that five years be the benchmark for initiation of development to classify quantities as reserves. "This became an issue outside the U.S., so we put in exceptions that a reasonable time frame longer than five years could be applied depending on the circumstance," he remarked.

Other major changes include using forecast conditions as the base case and applying the PRMS to unconventional resources, which are growing in importance.

Cutoffs presented by Dames

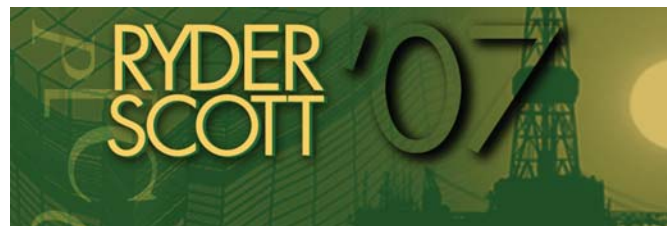
George Dames, managing senior vice president at Ryder Scott, presented an auditor's approach to cutoffs in the assessment of reserves at the Ryder Scott Reserves Conference in May. Recognizing an industry mindset, he said, "Geologists want to tell you how much is there but don't want to tell you how much can be produced because that is an engineer's problem."

Dames suggested that the use of cutoffs, which define what portion of the in-place quantities are produced at the surface, helps solve the engineer's problem in integrating the G&G and engineering analyses.

Dames explained how to establish cutoffs through analyses of test data, analogy and integrated reservoir studies. Cautioning that single well tests can only establish cutoffs in very homogeneous zones, he recommended multiple tests across different layers.

In discussing analogies, he said a good reference is SPE paper, No. 102505, "The Selection, Application, and Misapplication of Reservoir Analogs for the Estimation of Petroleum Reserves," written by **John Hodgkin**, president, and **Ron Harrell**, chairman emeritus, at Ryder Scott. For a summary of the paper, please see *Reservoir Solutions* newsletter, September 2006, Page 1.

Dames said to clearly establish production and pressure trends in the integrated reservoir study and to recognize the limitations of early-life, arbitrary constraints on productive area and reservoir volume.



- Almost 150 professionals attended the one-day Ryder Scott Reserves Conference in Houston. The conference presentations are posted under What's New at ryderscott.com.

The Fourth Annual Ryder Scott Reserves Conference in 2008 is scheduled to be held in Houston on Friday, May 9, the day after the 2008 Offshore Technology Conference concludes. For more information, send an e-mail to **Mike Wysatta**, business development manager, at mike_wysatta@ryderscott.com.

- **John McLaughlin**, petroleum engineer at Ryder Scott, presented, "The Uses and Misuses of Pressure Data for Reserves Estimation," at the conference. His presentation was based on SPE paper, No. 103221, cowritten by **Brad Gouge**, also a petroleum engineer at Ryder Scott. For a summary of that paper, see *Reservoir Solutions* newsletter, September 2006, Page 2.

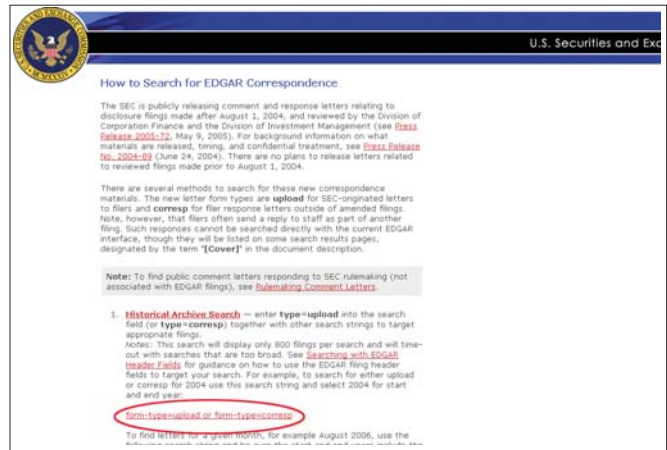
- **Larry Nelms**, managing senior vice president, presented a one-hour ethics course, required as a CEU annually for state-licensed petroleum engineers.

SEC posts comment letters

The U.S. Securities and Exchange Commission recently posted comment letters and correspondence between the agency and public issuers, including publicly owned oil and gas companies. Correspondence focuses on filing issues, including petroleum reserves filings, from August 2004 to 2007.

At the Ryder Scott Reserves Conference in May, John Hodgin, president, presented a step-by-step process to access comment letters involving specific public companies. The procedure is as follows:

1. Go to www.sec.gov/answers/edgarletters.htm.
2. Click on the link, “form-type=upload or form-type=corresp.” See circled area on screen shot of Web page.
3. Click on end of the search string, press the space bar once and key in “company-name=XYZ” where XYZ is the company name.
4. Modify start and end dates as desired.



5. Click on search and the results are displayed.

The SEC allows filers to request confidential treatment for portions of the written responses and releases only the redacted versions.

SEC and Exxon spar on year-end vs. internal price forecasts



The posted SEC comment letters (see article above) include debate between the SEC and Exxon Mobil Corp. on whether the company should be allowed to report two sets of reserves in its 2006 10-K—one based on year-end prices, the other on price assumptions used for planning and budgeting.

The correspondence shows that Exxon Mobil had subtotaled a reserves quantity calculated from internal prices and adjusted it for the impact of year-end prices for a total. The SEC contended that only one set of reserves should be reported, namely proved reserves using year-end prices. The agency cited FAS 69 and Regulation S-X, Rule 4-10 in its interpretation. Exxon Mobil disagreed.

“We said that we would incorporate year-end pricing into our proved reserves estimates. We have



done this but we have also shown the proved reserves volumes consistent with how we believe they should be calculated.”

“We also do not believe that calculating a subto-

total before showing the impact of year-end price revisions is prohibited by FAS 69 nor is it counter to Instruction 5 of Item 102 of Regulation S-X since that instruction seems intended to prohibit the disclosure of probable or possible reserves. We consider the volumes we are disclosing to be proved reserves,” stated Exxon Mobil. The company said that reserves calculated on year-end prices mislead investors, including reserves under production-sharing agreements. Ultimately, Exxon Mobil complied with the SEC interpretation, reporting one set of reserves numbers.

Opinions vary on SEC’s intention to change reporting rules



Speculation grew in May as to whether the U.S. Securities and Exchange Commission is planning to modernize petroleum reserves reporting standards, as the agency sought to fill an opening for an academic fellow-

ship for a petroleum engineering professor. The SEC posted the position for a candidate with experience as a petroleum reservoir engineer estimating reserves under various guidelines and with a familiarity of

petroleum accounting. The academic fellow will be involved in the works of the commission for a year and may be retained through an 18-month extension.

The *Wall Street Journal* in a May 2 article quoted sources indicating that the SEC action may be a first step in a modernization process. The SEC rules have not changed since 1978.

Others are less convinced, citing the SEC’s decision to decline an invitation to serve as an observer on the SPE Oil & Gas Reserves Committee. The committee developed a reserves system that was jointly approved in late March.

Observers see a possible change coming as soon as two years. The SEC said that it is on track to remove

Please see SEC on Page 8

Rietz: Think of reliable modeling results as an analog

Dean Rietz, managing senior vice president, recently discussed the concept of using reservoir simulation modeling results as an analog. For example, an evaluator can use a low-side recovery factor from a reliably built, calibrated model as an analog to estimate reserves from an immature field with sparse production performance, he said.

The subject field, though, should meet all other regulatory reserves constraints if the analysis is related to public reporting. For instance, the U.S. Securities and Exchange Commission generally requires that the subject field have log-derived lowest known contacts and a definitive well test.

With those conditions met, the evaluator applies the model-generated “proved RF” to 1P in-place numbers to get a reliable volumetric estimate. Rietz said that the RF should be generated from a model with assumptions that meet the test of reasonable certainty.

“The assumptions should be on the low side of what has been observed in the field—for instance, a low-side number for permeability. This same ‘conser-

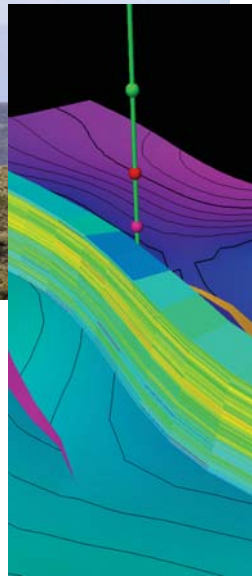
vative’ approach is used in selecting appropriate analog fields,” he remarked.

Rietz cited an SEC standard that the subject field must demonstrate equal or more favorable characteristics for every reservoir property than the analog field. Because the analog in this case is a model and not a field, Rietz warned against using modeling results to replace available analog field data, particularly for SEC reporting.

The agency has not publicly commented on the use of this approach and has only minimally commented on the use of reservoir simulation for estimating proved reserves.

Rietz’s discussion of models as analogs was part of his overall Ryder Scott reserves conference presentation on the use of models for estimating reserves. He plans to deliver a similar presentation, based on his SPE paper No.110066-PP, at

the 2007 SPE annual conference in November. Adnan Usmani, petroleum engineer at Ryder Scott, was co-author of the paper.



Russian deputy director calls for countrywide reserves review



Mitvol

The deputy director of Rospriradnador, a Russian inspectorate for mining licenses and environmental protection, accused a major third-party reserves evaluation consultant in April of faulty estimation practices and reserves manipulation,

news media reported. Oleg Mitvol also alleged that the firm’s client overstated its petroleum reserves in a Siberian field by several fold. The consultant allegedly responded that the audit is only as good as the geological data provided by the client, an analyst at a Moscow investment bank told the press.

Mitvol called for the Federal Security Service to review all estimates of foreign companies extracting minerals in Russia since 2003, remarking that producers are inflating values to profit from higher share prices. Analysts questioned the allegation, citing the consultant’s longstanding reputation and saying that it is unlikely the producer would construct pipelines if the field could not deliver oil and cash flow tied to

reported numbers. Mitvol said he planned to meet with another reserves consultant to review its operations in Russia.

The Dow Jones news service commented that Mitvol figured prominently in what appeared to be a carefully orchestrated government campaign to pressure Sakhalin Energy Investment Co. Ltd. into transferring control of its Sakhalin 2 project to OAO Gazprom. Critics say Mitvol may be aiming to undervalue foreign-owned property interests to prepare for renegotiations or acquisitions by state-owned companies.

The press also reported that the Ministry of Natural Resources raised the differences between international standards and the Russian system of reserves reporting at a meeting with the consultant and client. The consultant reportedly reconfirmed its reserves calculations in the competent person’s report.

Editor’s Note: The intent of this article is to make industry aware of important news events in the petroleum reserves sector. Ryder Scott intentionally did not identify companies cited in the news coverage. Readers wanting more detailed information should refer to business and trade periodicals covering this story.

Evaluating reservoir simulation history matches—Part 2

Dean Rietz, managing senior vice president, and Adnan Usmani, petroleum engineer, outlined a systematic review of the history match in their SPE paper No. 96410, “Reservoir Simulation and Reserves Classifications—Guidelines for Reviewing Model History Matches To Help Bridge the Gap Between Evaluators and Simulation Specialists.”

The first four of nine steps in the history match review were presented in the previous newsletter, Part 1. Steps five through nine are presented here.



Look for reasonableness in modifications to achieve match—After the engineer concludes that the field and wells are sufficiently matched, then he determines whether the changes to achieve the match

were reasonable. If changes are difficult to justify geologically, the engineer seriously questions the model forecasts. Attributing hydrocarbons to an area unlikely to have those volumes usually indicates other problems with the model. Unusual input parameters—such as high porosity, low residual saturations or high compressibility values—or awkward geologic features—such as permeability barriers surrounding a single well or grid-cell pipelines connecting an aquifer to a single well—are signs of potential problems.

The engineer is especially concerned with single-well fixes. Frequently, models are history matched by making alterations in the immediate vicinities of individual wells. These modifications include transmissibility modifiers to stave off advancing water, pore-volume increases or decreases to better match pressures and alterations to relative permeability endpoints. Often, such changes are made to the column of cells a vertical well penetrates, possibly including the surrounding columns. The engineer pays attention to the fashion in which that is implemented, particularly if automatic history-matching techniques are used. Such changes, if common, may indicate that a degree of heterogeneity is not properly expressed throughout the remainder of the model in the cells without wells. This heterogeneity or compartmentalization should be distributed throughout the rest of the model. Otherwise, any infill wells that are added will not feature the heterogeneity that the history match has shown is present.

Usually the model requires changes from the original description to match the historically observed well performance. Although rare, a model requiring few changes is usually a strong endorsement of the

initial model construction and geological interpretation.



Review transitions to prediction model—The engineer usually reconfigures the final history-matched model to predict reservoir behavior. Those prediction cases are usually set up by specifying a pressure—either BHP or THP—at which the wells will operate. The simulator calculates production volumes and relative portion of the phases based on specified operating pressures, completion data and surrounding reservoir conditions. An alternative for artificially lifted wells is to impose a constant liquid or gas rate and then to impose a minimum flowing BHP or THP that cannot be violated. In general, the engineer assigns either a total liquid rate or a flowing BHP or THP to wells for future predictions.

When transitioning from history matching to prediction, the phase rate profiles should be smooth, if new wells are not added or existing wells shut-in and if the fundamental constraints on the wells (flowing BHPs) are not changed. This is true of both field and individual well rates. When transitioning from history-match mode to prediction mode, the rates should not shift up or down. A shift usually indicates that the well is not calibrated.

In the calibration mode, the engineer adjusts each well's productivity to tie recent rates to recent flowing bottomhole pressures within the model. This process is typically iterative, but depends upon the interference between the wells.

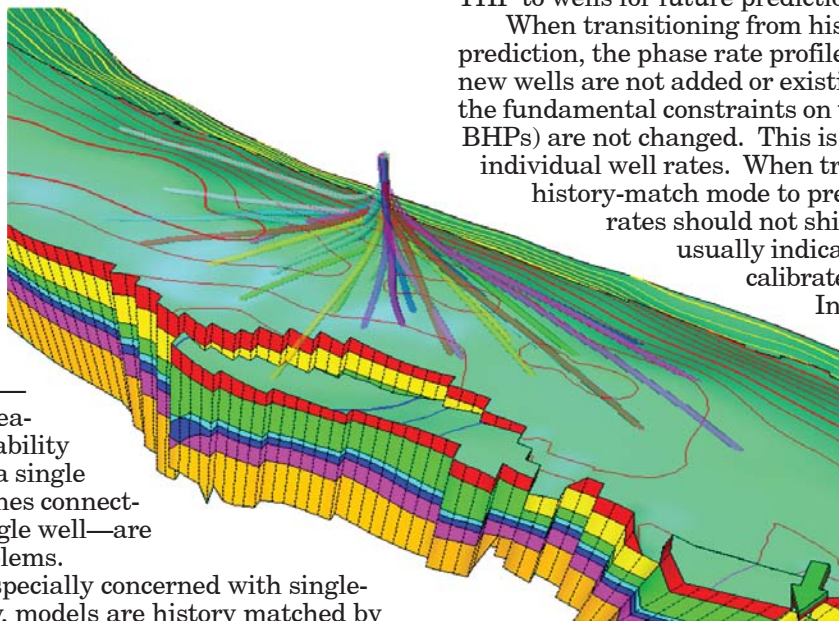
This step ensures

that the model wells are reasonably predicting the future performance of the actual wells. If a very robust model incorporates numerous factors influencing individual well productivity—such as skin damage, partial penetrations or stimulation treatments—then an adjustment may not be necessary, but this is rare.



Evaluate reasonableness of status quo case and appropriateness of forecast cases—An expeditious test or “status quo” case helps identify the quality of a model. This is a prediction run where the past operating practices are continued into the future. For example, if the future decline rate in a depletion-drive reservoir as predicted in the model is consistent with both the historical decline and the extrapolated decline curve, then the model should be viewed as a good predictor of performance.

The status quo case provides insight into whether the model is constructed and history matched so that it can reasonably predict future performance, if the field continues operations as is. One question is whether



the model is a reasonable predictor if operations materially change. For instance, if a model of a depletion drive oil field is placed under field-wide water flood in the prediction mode, the engineer must determine a degree of confidence in the forecast. If the history of the field featured a waterflood pilot project and the history match captured the response, then the degree of confidence can be high.

If the pilot project was not history matched, then confidence is low. The engineer also examines whether the data that drives the process has been laboratory measured or merely assumed. More importantly, he also assesses whether the results are reasonable for the type of process that is introduced. In cases where no pilot has occurred, data can originate from a wealth of sources, including fine-scale mechanistic models.

In many cases, a new exploitation process will not depend upon characteristics that are strongly determined through history matching. For instance, in the case of a depletion drive gas reservoir exploited by vertical wells, variances of vertical permeability may make almost no differences in the history match.

If horizontal wells are added to the prediction run, then poorly resolved vertical permeability may make a tremendous difference in the forecast rates and recovery. Thus, if good data is not available for a non-history matched process, then sensitivity studies may be required to assess the variability of potential recovery and rate forecast to parameters that were

only poorly resolved during the history match. Fortunately, changes to flow rate constraints and operating pressures and the addition of infill wells usually do not require a history-matched pilot.



Assess overall quality and validity of model— It is important to evaluate the overall quality of the model and its history match. A quality match depends on the reasonableness of model construction and projections.

Modeling immature fields is most challenging when considering simulation model validity. It may not be possible to exclude scenarios because of the lack of historical data. Instead the results from each of the multiple realizations should be used to construct a type of results matrix assigned to estimate the range of uncertainty in the modeled scenarios.



Consider the model as an analogous field—An engineer's use of the results of simulation models is similar to his use of performance data from an analogous field. The better the geological understanding and the overall history match, the more closely this analogous field matches the subject field. For more information, see article on Page 5, "Rietz: Think of reliable modeling results as an analog."

Editor's Note: This article is a revised excerpt from SPE paper No. 96410. To order the full paper, go to spe.org.

Upcoming Events

June 13-14—SPE EUROPEC, London. Short course on reserves presented by John Hodgkin, president and Bob Wagner, former senior vice president. Go to spe.org for details.

June 24-26—AAPG/SPE Multidisciplinary Conference on Oil and Gas Reserves and Resources, Washington, D.C. Go to aapg.org to request an invitation.

Sept. 17—SPE distinguished lecturer Ron Harrell, chairman emeritus, presents history, current status and future of reserves estimates at Illinois Basin Petroleum Section in Grayville, IL. Go to SPE section Web site for details.

Sept. 18—Presentation to Midwest Gas Storage Section in Bloomington, IL. See Sept. 17 for speaker, topic and source of further details.

Sept. 19—Presentation to Northern Michigan Section in Traverse City, MI. See Sept. 17 for speaker, topic and source of further details.

Sept. 20—Presentation to East Kentucky Section in Paintsville, KY. See Sept. 17 for speaker, topic and source of further details.

For production to be reserves, degree of ownership required

All service contracts are not the same

Companies reporting proved reserves under international agreements to the U.S. Securities and Exchange Commission have always relied on SEC Section S-X, Rule 410-b for guidance on ownership and reserves recognition. This rule tends to recognize proved reserves if the contractor has the right to extract oil or gas, to take volumes in kind, has a clear mineral interest and is exposed to risk and potential reward.

Not all four are needed, but the ability to book proved reserves increases as more of the ownership indicators are in place. Also, the five fiscal systems that generally involve degrees of ownership, from least to most, are loan agreements, pure service contracts, revenue sharing contracts, production sharing contracts and concessions.

Countries, such as Bolivia, are changing to service contracts amid rising economic nationalism. "Can companies register reserves at stock exchanges? I clearly tell them, 'No,' because the owner is the Bolivian state," Bolivia energy minister Carlos Villegas said, according to local news reports in March.

Companies under pure service contracts are not allowed to report production as reserves to the SEC. However other companies under risked service contracts with capital at risk have been successful in convincing the SEC that the produced volumes are proved reserves.

Dames elected to board, petroleum engineer joins RS



Dames

George Dames, managing senior vice president, was elected to the Ryder Scott board of directors in March. The geology group leader manages G&G teams involved in numerous international studies. Dames has evaluated properties in Argentina, Bolivia, Colombia, Ecuador, Brazil, Venezuela, western Siberia, Russia, Ukraine, China, Kuwait, Egypt, Trinidad and Tobago, offshore

West Africa and Indonesia. He joined the firm in 1993. Before that, Dames was an independent consultant for two years. During 1985 to 1991, he was an exploration geologist at Wagner and Brown developing and screening U.S prospects. Dames started his career as a geologist in 1975 at Southern Natural Gas Co. after graduating from Rice University with a BA in geology that year. Four years later, he joined Texasgulf Oil and Gas Co. as an exploration geologist and also worked at Texas General Petroleum Co. and Andress Petroleum Inc. until 1985.



Jeanes

William (Frank) Jeanes recently joined Ryder Scott as a petroleum engineer. Before that, he worked as a consultant for more than 10 years. Jeanes conducted reserves audits and evaluations for acquisitions and divestitures. He also reviewed and prepared workover recommendations and evaluated EOR and tertiary recovery projects for determination of tax credits. In addition, Jeanes determined the commerciality of miscible

and immiscible injectant projects throughout the

continental United States.

Before that, he worked at North Central Oil Corp. during 1982 to 1986 as a chief reservoir engineer where he performed oil and gas reserves determinations and economic evaluations. Jeanes worked at Sipes, Williamson & Assocs. Inc. during 1977 to 1982 as a senior engineer performing oil and gas reserves determinations and economic evaluations for clients. After receiving a BS degree in petroleum engineering from the University of Texas in 1971, he began his career at Texaco Inc. where he worked until 1974 as a reservoir petroleum engineer. Jeanes was a senior engineer at Houston Pipe Line Co. during 1974 to 1977.

SEC—Cont. from Page 4

the reconciliation requirement between the International Financial Reporting Standards and U.S. GAAP by 2009.

If the SEC adopts international standards for petroleum accounting, then its reserves reporting rules may also change. The International Accounting Standards Board, which develops IFRSs, is considering adopting the new SPE guidelines. The IASB-U.S. Financial Accounting Standards Board joint effort to converge and harmonize financial accounting practices would effectively be the agent of change.



Don Roesle, left, CEO at Ryder Scott, and Li Yang, director of Sinopec oilfield E&P dept., recently met at Ryder Scott offices.

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