Managing the Time Warp – Application of the SEC 5-Year Rule

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Presentation Outline

• SEC Mission and Objectives

• Importance of SEC Compliance

• Definition & Disclosure Requirements for Proved Undeveloped

• Impact of SEC Modernization to Reserve Bookings

• Pace of Development

• Undeveloped Reserves to Developed Reserves

• Managing Undeveloped Reserves
SEC Mission and Objectives

- The SEC’s mission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation.

- SEC does not evaluate the merits of any transaction or make any determination as to whether an investment is appropriate for any investor.

- The SEC requires companies whose securities are publicly traded to disclose meaningful financial information such that all investors will have access to certain basic facts about an investment prior to buying it, and so long as they hold it.


Source: www.sec.gov/about/whatwedo.htm
Why Compliance is Important

- Public and legislative demand for increased surveillance of U.S. SEC filers (10K or 20F) since Enron fiasco in 2001

- SOX mandated SEC 3 year review cycle for companies who sell securities (stock and other financial instruments) on a U.S. stock exchange (10K or 20F filers)

- Public disclosure of SEC “Comment Letter” exchanges starting Aug 1, 2004

Modernization of Oil and Gas Reporting

Amends, Codifies and Revises

- Regulation S-X
- Regulation S-K
- Industry Guide 2

Set forth guidelines for:

- Reporting and Disclosure in Annual Reports (10-K and 20-F)
- Reserves Definitions

- Rules & Regulations for Oil and Gas Reserve Reporting and Disclosures
- Amends and Implements New Standards
- Issued January 2009
§ 210.4-10 (31) Undeveloped oil and gas reserves.

Undeveloped oil and gas reserves are reserves of any category that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for recompletion.

(i) Reserves on undrilled acreage shall be limited to those directly offsetting development spacing areas that are reasonably certain of production when drilled, unless evidence using reliable technology exists that established reasonable certainty of economic producibility at greater distances.

(ii) Undrilled locations can be classified as having undeveloped reserves only if a development plan has been adopted indicating that they are scheduled to be drilled within five years, unless the specific circumstances, justify a longer time.

(iii) Under no circumstances shall estimates for undeveloped reserves be attributable to any acreage for which an application of fluid injection or other improved recovery technique is contemplated, unless such techniques have been proved effective by actual projects in the same reservoir or an analogous reservoir, as defined in paragraph (a)(2) of this section, or by other evidence using reliable technology establishing reasonable certainty.

Source: Title 17, Code of Federal Regulations, Modernization of Oil and Gas Reporting, Final Rule released January 14, 2009 in the Federal Register. All page numbers herein refer to those of the Federal Register.
§ 229.1203 (Item 1203) Proved undeveloped reserves.

a) Disclose the total quantity of proved undeveloped reserves at year end.

b) Disclose material changes in proved undeveloped reserves that occurred during the year, including proved undeveloped reserves converted into proved developed reserves.

c) Discuss investments and progress made during the year to convert proved undeveloped reserves to proved developed reserves, including, but not limited to, capital expenditures.

d) Explain the reasons why material amounts of proved undeveloped reserves in individual fields or countries remain undeveloped for five years or more after disclosure as proved undeveloped reserves.

Source: Federal Register pg. 2195
Impact of SEC Modernization to Reserve Bookings

• 12 of the Top 50 10-K filers took downward revisions to proved undeveloped reserves due to 5 Year Rule at December 31, 2009
  – Revisions totaled approximately 0.5 Billion net BOE

• Additional revisions resulted from Comment Letter process and in future filings
  – Petrohawk debooked 0.1 Billion net BOE in December 31, 2010 10-K filing
SEC Scrutinizes Year End Filings

Breakdown of SEC Comments

SEC Comment Letters Issued 12/31/2009 Year End Filings
Top 100 10-K & Top 10 20-F Filers Combined*

- No Ltr
- Receiving Ltr

5 Year Rule

- Most Reviewed
- Technical Issue

63
35
27

Disclosed Information

- Engineering Questions
- 5 Year Rule
- ReTo, Offsets, DCA
- Parameters, etc

5 Year Rule
Most Reviewed
Technical Issue

Reserves and Resources Reporting
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Breakdown of Questions Relating to Timeframe and Commitment to Convert Reserves from PUD to Dvl
“You state that you developed 81 million barrels equivalent of proved undeveloped reserves in 2009. This represents approximately 19% of your total proved undeveloped reserves at year end 2008 and 10% of your proved undeveloped reserves at year end 2009.

This rate of development of your proved undeveloped reserves at year end 2009 suggests that it will take approximately 10 years to develop all of your proved undeveloped reserves, assuming that no additional proved undeveloped reserves are added during that time.

As proved undeveloped reserves should generally be developed within five years of initially booking them as proved, please tell us your plan to accomplish this.”

Source: Devon SEC Comment Letter Correspondence Apr 14, 2010; Question 5
10-K Disclosure Information

Required SEC Disclosure Information Provides Data for Two Key Metrics in SEC Test of 5 Year Rule

1. **Track Record** of converting PUD volumes reported in the prior year filing

2. **Pace of development** which relates track record to PUD volumes reported in current filing
Implications

• Track record of the previous year may not be indicative of the pace of development in future years

• But, the SEC will be asking companies to justify their PUD volumes

• How can PUD disclosures provide clarity & granularity
Converting Undeveloped Reserves to Developed Reserves

Interpretative Issue

How are in-year reserve movements relating to the development and conversion of Proved Undeveloped Reserve volumes recognized for annual reports filed with the SEC?
Converting Undeveloped Reserves to Developed Reserves

• Language contained in § 229.1203 (b) & (c) lacks specificity

• Lacks a clearly defined starting reference point
  
  – Converted volume quantities

  – Associated capital expenditures

• Interpretative differences may occur for the in-year reconciliation

Source: Federal Register pg. 2195
Interpretative Position – Scenario 1

Reconcile the beginning Proved Undeveloped balance with only those activities that impact the beginning balance.

Scenario 1

Disclosure that 1 unit volume of Pv Undvl was converted to Pv Dvl during 2011.
Include new activities that were not in the beginning balance, but were recognized as Proved Developed by year end.

Scenario 2

Disclosure that 2 unit volumes of Pv Undvl were converted to Pv Dvl during 2011.
Interpretative Position

SEC disclosure requirements are specific to activities related to Pv Undvl reserves in the opening balance

– Address the reason for changes

– Quantify the volumes and associated capital expenditures

– Specific to activities which result in the conversion of previously reported Pv Undvl reserves to Pv Dvl reserves during the year
“Modernization” Section IV.4 (pg. 2176 – 2177)

We are adopting rules that require a company to disclose the following in narrative form:

- The total quantity of PUDs at year end;
- Any material changes in PUDs that occurred during the year, including PUDs converted into proved developed reserves;
- Investments and progress made during the year to convert PUDs to proved developed oil and gas reserves; and
- An explanation of the reasons why material concentrations of PUDs in individual fields or countries have remained undeveloped for five years or more after disclosure as PUDs.

- Dr. John Lee acknowledged intent of requirements in order to establish a track record

- SEC comment letters identify the point of reference as the opening balance with activities limited to PUDs already on the books
Interpretative Position – Optional Disclosures

In addition to disclosure regarding conversion from Pv Undvl to Pv Dvl, optional disclosure of new activities that were not in the beginning balance, but were recognized as Proved Developed by year end:

- Recognized as supplemental information
- Provides additional clarity and granularity
- Better indication of company’s track record of converting reserves to Pv Dvl
“Modernization” Section V (pg. 2179)
Guidance for Management’s Discussion and Analysis for Companies Engaged in Oil and Gas Producing Activities

- Changes in proved reserves and, if disclosed, probable and possible reserves, and the sources to which such changes are attributable, including changes made due to...
- The company’s recent ability to convert proved undeveloped reserves to proved developed reserves, and, if disclosed, probable reserves to proved reserves and possible reserves to probable or proved reserves;

- Discussions with Dr. John Lee and accounting partners Pricewaterhouse Coopers and Deloitte Touche Tohmatsu recognized as supplemental disclosure

- SEC comment letters regarding supplemental disclosures
Managing Undeveloped Reserves

SEC Disclosure for 12/31/2011 Year End Filing
Including the In-Year Changes for New Pv Undvl Reserves

Conclusions-SEC Disclosure Under § 229.1203 (b) & (c)
*A-Mandatory disclosure: 1 unit volume of reported Pv Undvl was converted to Pv Dvl during 2011
*B-Supplemental disclosure: 1 unit volume of new Pv Undvl was converted to Pv Dvl during 2011 for total of 2 unit volumes of Pv Undvl converted to Pv Dvl during 2011
Managing Undeveloped Reserves & 5 Year Rule

• Beyond the initial filing date
  – Track Record
  – Pace of Development

• Process will be unique from company to company

• Tracking should distinguish different movements

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Questions

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SEC Comments Relating to the Conversion of PUD Reserves

Letter Dated: May 18, 2010
Topic: Proved Undeveloped Reserves
Reference: 12/31/2009 10-K Filing

Question:
We note that you have disclosed your beginning and ending PUD amounts and discussed the amount of PUDs that have been converted to proved developed reserves during the year. Please tell us the consideration you gave to disclosing the reasons for the material increases to your PUD that occurred during the year, either here or under Management’s Discussion and Analysis.

Response:
We believe our disclosure of proved undeveloped reserves (PUDs) on page 8 of our Form 10-K satisfies the requirements of Item 1203. We did not report a significant increase in PUDs from year-end 2008 to year-end 2009; the 3 MMBOE increase from year-end 2008 to year-end 2009 represents a 0.4% increase in total PUDs. We disclose, on page 8 of our Form 10-K, that we converted 100 MMBOE of PUDs that were included in our year-end 2008 PUD disclosures to proved developed reserves in 2009. We believe this disclosure satisfies the requirements of Item 1203(b). We also disclose, on page 8, our 2009 spending for the development and conversion of PUDs to proved developed reserves, and on pages 8 and 9, we make specific reference to the major development projects receiving PUD-development capital in order to satisfy the requirements of Item 1203(c). Given the insignificant change in our PUDs from year-end 2008 to year-end 2009, we concluded that further discussion of our PUD increases, beyond PUD-conversion spending that occurred during the year, would not provide additional information that is material to our investors. In future filings, should our level of PUDs change materially compared to the prior period presented, we would include appropriate disclosure describing the reasons for such material change.

Source: Anadarko SEC Comment Letter Correspondence May 28, 2010; Question 3
SEC Comments Relating to the Conversion of PUD Reserves

Letter Dated: July 2, 2010
Topic: Proved Undeveloped Reserves
Reference: 12/31/2009 10-K Filing

Question:
In our prior comment number 13, we asked that you disclose your prior three years’ conversion rates for proved undeveloped reserves to developed status as contemplated by Section V of Securities Act No. 33-8995, Modernization of Oil and Gas Reporting. *We do not agree with your position that such information is not meaningful to investors.* Therefore, we reissue our prior comment number 13.

Response:
(Only an excerpt of Newfield’s response is shown herein, refer to the original SEC CORRESP response by Newfield.)
The below table *summarizes the percentage of our proved undeveloped reserves converted to proved developed reserves by year* for the last four years in each of our major fields and for our Gulf of Mexico and offshore Malaysia regions. An explanation for each is set forth below the table.

Accordingly, we do not believe that historical conversion rates are indicative of future plans and cannot be used as a measure of whether the proved undeveloped reserves will be converted to proved developed reserves within five years. To enhance its disclosure, in future filings Newfield will include a discussion regarding the future development of our proved undeveloped reserves. An example of our disclosure in Items. 1 and 2. “Business and Properties” in future filings is as follows: *In the years 2007-2009, we developed 26%, 17% and 11%, respectively, of our prior year end proved undeveloped reserves.*

Source: Newfield SEC Comment Letter Correspondence July 29, 2010; Question 2
SEC Comments Relating to the Conversion of PUD Reserves

Letter Dated: June 16, 2010
Topic: Proved Undeveloped Reserves
Reference: 12/31/2009 10-K Filing

Question:
Although you have disclosed how many proved undeveloped reserves you converted to proved developed reserves in 2009 and how many proved undeveloped reserves you removed due to not developing them within five years, you have not disclosed any other changes to proved undeveloped reserves. Please revise your document to discuss the changes that correspond to the line item reserve changes found in paragraph 932-235-50-5 of FAB ASC.

Response:
(Only an excerpt of Chesapeake’s response is shown herein, refer to the original SEC CORRESP response by Chesapeake.)
We are not aware of any guidance that requires registrants to apply the rollforward categories applicable to total reserves in the referenced accounting standard to the changes in PUD reserves disclosures required by Item 1203(b). We note, for example, that there is no category in ASC 932-235-50-5 to account for PUDs converted into proved developed reserves, a disclosure item specifically called for in Item 1203(b).

Source: Chesapeake SEC Comment Letter Correspondence June 30, 2010; Question 4
Question:
(Only an excerpt of the SEC’s question is shown herein, refer to the original SEC CORRESP response by Chesapeake.)
We note your responses number 4 and 10. You currently discuss the changes in your PUDs in two different locations and the explanation for those changes is split between various locations.

Response:
(Only an excerpt of Chesapeake’s response is shown herein, refer to the original SEC CORRESP response by Chesapeake.)
We agree that our explanation of 2009 PUD reserve changes would have been clearer if this information appeared in one location. In future Form 10-K filings, when there are material changes in our PUD reserves, we propose to include a table or narrative in Item 1. Business that rolls forward the beginning PUD reserve balance to the final balance, indicating material extensions, discoveries and other additions during the year and material revisions for changes due to price, performance and deletions and for other reasons. We would also detail the amount converted to proved developed reserves, as required by Regulation S-K Item 1203(b).

Source: Chesapeake SEC Comment Letter Correspondence July 27, 2010; Question 2
Question:

We note as a result of 2009 drilling activities, you increased your proved undeveloped reserves with extensions and discoveries of 316 million barrels equivalent, and converted 81 million barrels equivalent to proved developed reserves. Please provide more specific disclosure by project on each of your drilling activities and how they contributed to the increase in your proved undeveloped reserves.