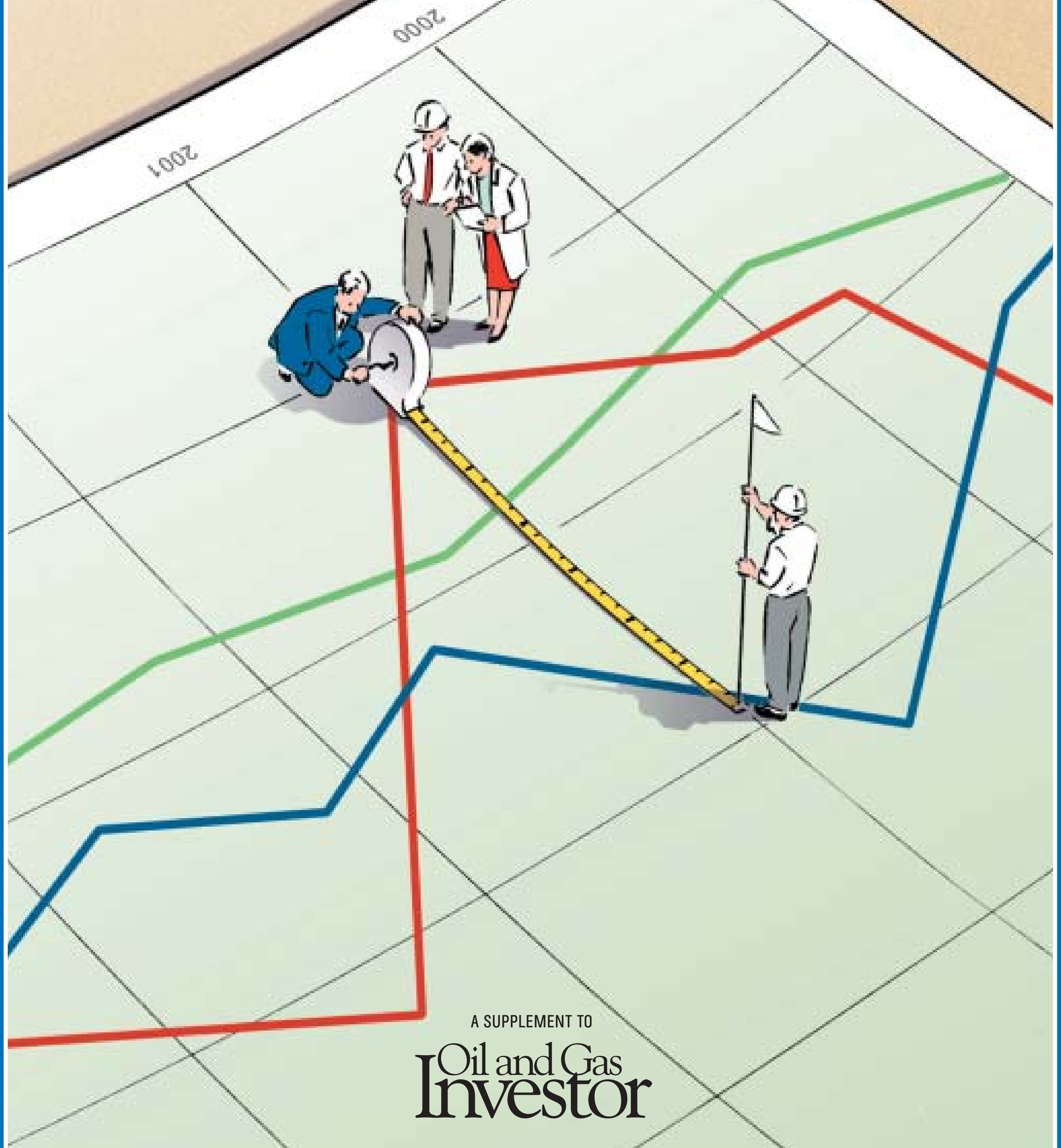
The E&P Consultants Directory 2005



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4545 Post Oak Place, Suite 210
Houston, Texas 77027-3105
713-993-9320
Fax: 713-840-8585
OilandGasInvestor.com

Editor-In-Chief
Leslie Haines
Ext. 151, lhaines@hartenergy.com

Executive Editor
Nissa Darbonne
Ext. 165, ndarbonne@hartenergy.com

Art Director
Marc Conly

Production Manager
Jo Pool
Reprint Sales & Photo Rates
Ext. 136, jpool@hartenergy.com

Regional Sales Manager
Bob McGarr
Ext. 144, bmcgarr@hartenergy.com

Regional Sales Manager
Shelley Lamb
Ext. 118, slamb@hartenergy.com

Group Publisher
Bob Jarvis
Ext. 130, bjarvis@hartenergy.com

Hart Energy Publishing, LP

Sr. Vice President & CFO
Kevin F. Higgins

Executive Vice President
Frederick C. Potter

President & Chief Executive Officer
Richard A. Eichler

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The E&P Consultants Directory 2005

With oil and gas prices at historic highs throughout 2004, E&P companies are happy and healthy this year, paying down debt and returning dividends to shareholders. Everybody looks like a winner. So, why would any company need to call upon a consultant, you ask?

Complying with Sarbanes-Oxley, for one. More confident reserves reporting, for two. Facing increased regulatory scrutiny, for three. Sustaining 2004 results if and when commodity prices fall back to more normalized levels.

No matter how exquisite the orchestra is, the musicians fine-tune their instruments repeatedly and practice every day.

There is a larger force at play here as well. Energy executives must always look to the long term—to a future of increased U.S. oil and gas demand while domestic production becomes harder and more expensive to sustain, especially when coupled with a soon-to-be-smaller workforce. They are asking themselves where they need to take their strategy next in order to continue increasing their reserves and production, and at the same time, sustain returns that will continue to attract investors.

Business transformation and optimization never go out of style.

This directory is meant to point you in the right direction toward business consultants and professional service providers that guide companies to success.

—Leslie Haines, Editor-In-Chief

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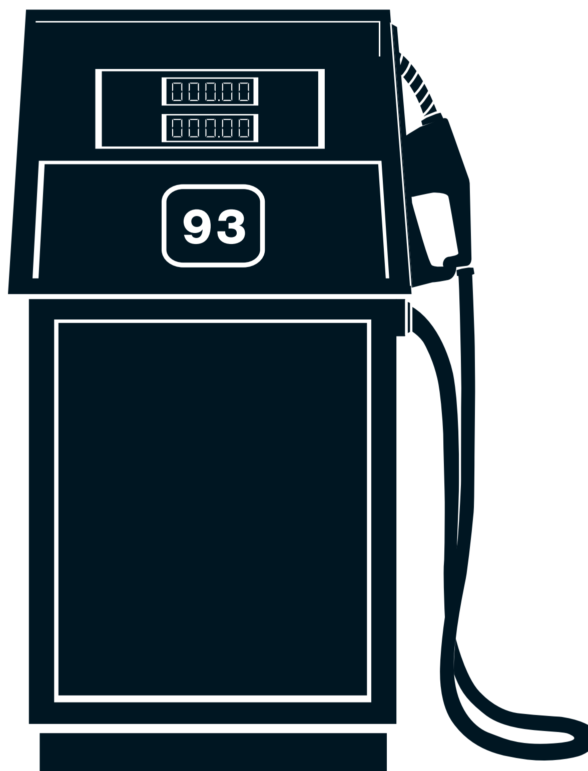

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Gulf Costs

Employing process changes on four offshore platforms, Shell bridged the gap between rising costs and declining output.

ARTICLY BY BARRY SAMRIA

Future prospects aside, some Gulf of Mexico production companies have more immediate concerns around efforts to control costs while trying to maximizing throughput. It is becoming more difficult to maintain lifting costs with some of their mature and deepwater fields declining potentially by almost one-third year over year.

How does an operator address declining production and rising costs, not only from more mature assets, but also from the more modern deepwater assets?

Shell, one of the largest Gulf producers, implemented an efficiency improvement program in 2001. The program looked at increasing throughput from existing assets, without the need for additional capital expenditure, while simultaneously reducing operational spending to reverse the trend of ever-increasing lifting costs.

Before the program was rolled out across all offshore and onshore assets, it was piloted across two asset groups that were representative of its mature offshore portfolio. Four platforms were included in the pilot program: two small and a larger "shelf" platform, along with a deepwater tension leg platform (TLP).

Throughput challenge

Prior to implementation of the pilot program, the organization had already developed a more robust model to better define the theoretical maximum throughput possible, taking into consideration all given factors, such as reservoir, wells, facilities and export pipelines.

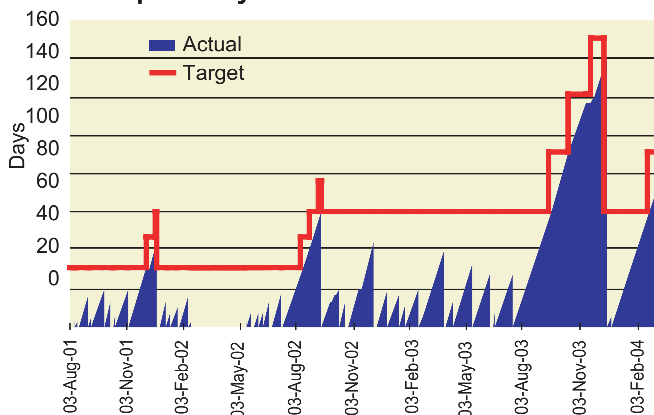
This was very important since the operators have to be confident that the production forecast and the daily production target are both realistic and achievable. This would provide the bedrock for process and key performance indicators (KPIs).

As soon as the program's implementation team began working offshore with the operations teams (production and maintenance), one of the first priorities was to develop and implement "short interval controls" or SICs to review critical process equipment at rigorous and regular intervals, helping minimize variability, thereby improving throughput by enabling better control of the processes.

The SICs were developed using Excel spreadsheets with macros, and the simplicity helped foster ownership of the tool with the operators.

For the program implementation team, the key for developing comprehensive process SICs was to understand the critical elements of the process that had most recently been the cause of trips, equipment downtime and/or production losses. After the critical elements were identified, upper and lower operating parameters were set well within the current recommended operating parameters.

Brutus Trip History



Spreadsheets were then developed and given to the operators who were asked to track the identified elements at defined intervals necessary to maintain better control—the goal being to prevent platform or equipment trips, thus minimizing and reducing production losses, which resulted in greater process stability.

Another benefit of greater process stability is that it created a more proactive approach to preventative maintenance and asset integrity, allowing for reductions in operating costs by reducing costs of materials and better utilization of manpower.

SICs continue to be reviewed by the production operators during their daily meetings to identify and understand issues that arose during the previous day and the actions that were taken to remedy non-compliance of critical equipment. This tool and process is now considered a critical aid in the development of the capability, knowledge and skills of the operations workforce.

Another direct benefit of the process SIC is that they have allowed for faster integration of new operators and also rapidly reduced training times for new personnel.

Since implementing process SICs, the results achieved have been outstanding. Record runtimes (days without a trip) have been achieved on nearly all platforms and asset utilization on the whole, ranging between 96% and 99% consistently.

Increased production and greater stability of processes aside, other additional benefits have also been evident, including a greater level of stability and accuracy in the production forecasting process, and an increased understanding and knowledge among operators of the platform's critical equipment and nuances.

Additionally, there is better and more accurate coding of deferment, which in turn allows better "root-cause failure analysis" to be conducted and actions more likely to prevent other such occurrences.

As management teams from any organization can attest, changing and sustaining new behaviors is never easy.

Driving down costs

A number of different operational expenditure areas were identified that could potentially deliver enormous cost benefit savings across the organization including call-off contractors, numbers of operational hourly and supervisory staff required to operate the platform, logistics, chemicals and materials.

Chemical costs. Utilizing similar principles in the development of the process SICs, chemical SICs were developed and rolled-out to track usage of all chemicals and understand the impact of likely conditions on chemical injection rates during any given day.

The frequency of the chemical SIC was considerably less than that for the process SIC. Again, as with the process SIC, the output of the chemical SIC would be shared and discussed during the daily meeting to understand if and why volumes greater than or less than planned had been injected during the previous day.

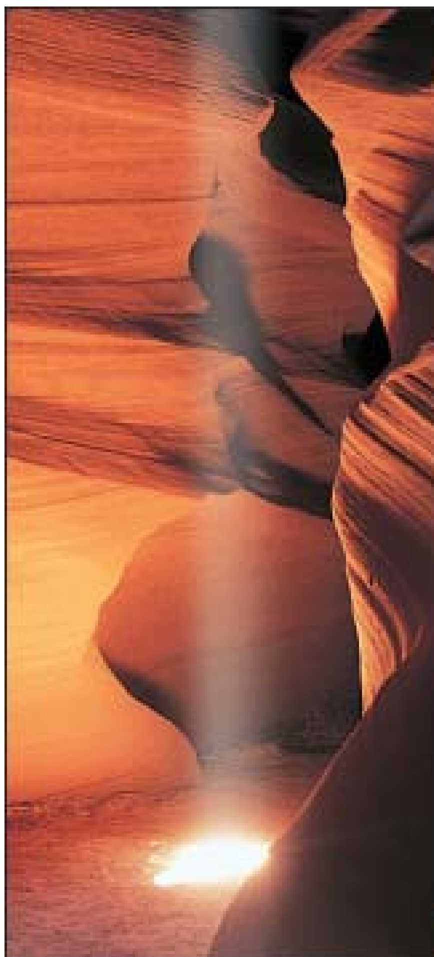
On each crew, one operator was nominated as the "Chemical Champion." The chemical champion would be accountable for ensuring that the chemical SICs were being populated in a timely manner each day, and an understanding had been developed for any unusual events that necessitated an increase or decrease in chemical injection rates. If any unusual events occurred, they would be shared with the team during the daily meeting.

Not only were chemical costs reduced 40%, but the levels of expertise developed by the platform operational staff in a very short period of time continue to serve the organization well in challenging chemical vendors with their recommended injection rates. As a result, all platforms that use large quantities of chemicals have achieved sizable reductions in their budgeted chemical spend.

Contractor spending. The program implementation team recognized very early the considerable scope and potential to positively impact contractor spend. To this end, the team developed a "contractor management process and system." The process primarily developed a framework to help better manage the call-out of contractors.

There are two key aspects to this system: it helps facilitate a decision on whether the work can or should be done without the need for a third-party contractor; and if a contractor is called out, it enables the team to more proactively manage the cost and quality of delivery from the contractor.

This process is designed to ensure absolute clarity of roles and responsibilities as well as expectations for all parties. The process also proactively facilitates the entire transac-



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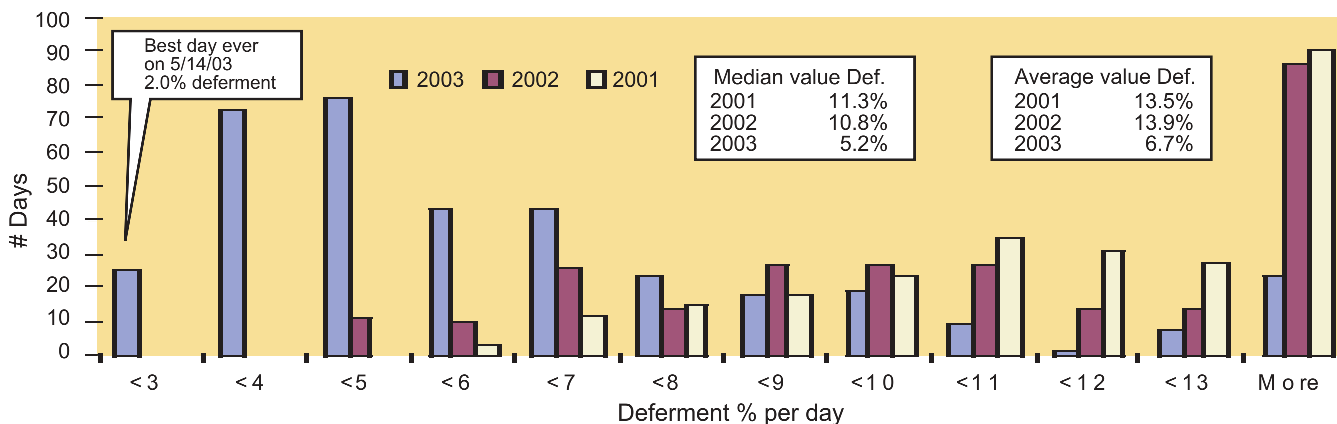

tion from the decision to call to the completion of the performance evaluation of the entire transaction. Equally important, it is not only the performance of the contractor that is being evaluated, but also the performance of the person doing the call-out and responsible for the contractor/vendor while on site.

This includes being fully prepared to receive the third party by ensuring work permits and materials are ready, and all planning and scheduling is complete—everything that needs to be done to ensure that the third party completes the work to schedule and no additional costs are incurred.

The dual party evaluations conducted at completion as part of the process ensure that learning is being captured and shared from these interactions and will continue to provide valuable lessons for both parties and improve the levels of cost, quality and service.

The system has enabled Shell to more efficiently and effectively utilize contractors, and subsequently reduced contractor spend considerably. The outcomes seen on this project with developing and implementing a contractor-management process and system are very similar to the results delivered in other geographies and organizational cultures.

Maintenance. Utilization of new tools and methodologies to maximize efficiencies in production and contractor spend were mirrored within the maintenance organization. The implementation of a new scheduling and planning process delivered considerable gains in resource utilization.

The ratio of preventative/corrective maintenance greatly improved, both on mature and the more modern deepwater assets. Backlogs have been dramatically reduced and are stable at pre-determined levels with daily and weekly schedule compliance consistently above 90% providing greater levels of stability and certainty for the maintenance teams during their working day.

Other costs. The project teams have made considerable inroads in other cost categories as well. There have been cost reductions of air logistics and materials as well as reductions in numbers and composition of operations teams.

The project team implemented tools and processes that provided greater visibility of breakdowns of total costs in the areas of concern. By engaging and empowering the wider operations community and providing visibility of cost structures, the impact of individual actions on these areas of cost generated accountability within the wider group for individual areas of cost, resulting in the total cost base could being impacted in a surprisingly short period of time.

Behavioral change

The key to any successful change-management program is the behavioral change necessary to truly deliver the full potential of identified benefits and equally important, sustaining those benefits through the disciplines of continuous improvement.

As management teams from any organization can attest, changing and sustaining new behaviors is never easy. It is, in fact, an inherently messy and difficult process that will usually be the cause of some casualties within the organization.

During the implementation phase of Shell's change program, it was important to be cognizant that the goal was to drive sustainability for all aspects of the change program. The challenges that the organization was going through demanded a more holistic approach. In designing the implementation program, many different facets that created value for the organization were considered.

Early on in the project, the implementation team developed the vision that delivering sustainable results can only happen with requisite change in behaviors, driving people to look at the business in a much more structured and focused manner.

Sustainability of change

During the early days of the implementation there were three key tools that were utilized to this end: the emotional cycle of change, a system-implementation schedule and a sustainability pyramid—a set of actions that constantly and consistently drives the organization towards constant, continuous improvement and sustainability of the program and the results.

As a result, Shell continues to utilize these tools in a manner that is likely to ensure sustainability of the program and its continuing results. Every organization is capable of delivering the results that were achieved by Shell, but to do so, one question needs to be answered adequately by the management team: What are your drivers for change, and do you want it badly enough?

Barry Samria is a client partner at Celerant Consulting specializing in the oil and gas sector with more than 10 years of experience in process improvement primarily in the North Sea and Gulf of Mexico. (Note: The Sustainability Pyramid is a trademark of Celerant Consulting.)

Going Where Others Fear to Tread

A number of insurance instruments can give buyers and sellers more comfort when energy assets change hands. Here is a rundown of some useful tools.

ARTICLE BY JOHN LUDWIG

To be successful in today's merger and acquisition environment, a company has to be agile and first in line. M&A professionals need to have all the tools necessary to be in and out of deals as quickly as possible.

Traditionally, most acquisitions take the form of an exquisite dance. The seller attempts to lessen real or perceived problem with an asset to ensure the highest value, and the buyer likes to make the impairment seem as big as possible in order to reduce the purchase price and protect for unknown liability.

Both parties dance with the issue, many times walking away from the deal because one side or the other cannot be comfortable with the price and exposure to risk. In the end, nobody wins.

"Gone are the days when you can show up at a cocktail party or get a CD in the mail and make a deal," said George Solich of Cordillera Energy Partners, speaking at the Oil and Gas Investor forum, A&D Strategies and Opportunities. "We are going to have to get back to the creative nature of the M&A business, get back to digging long and hard for opportunities."

There are opportunities to be had that may have some impairment, so have not seen the light of deal flow. The real question is, "How can a company take advantage of these opportunities without staying awake at night worrying about long-term liability?"

Insurance, used correctly, has the ability to enhance and even make it possible for companies to look at opportunities that have long-term liability issues.

The concept of transferring liability is not new; however, most great solutions are seldom remembered in the heat of negotiations. Often the insurance industry is of little help when doing tougher and riskier transactions. However, with a little thought, legwork and creativity, it can be used by those involved in M&A as another tool to close on those opportunities others have long written off as too difficult.

All involved in M&A should never shy away from potential opportunities that have issues. We would suggest looking for opportunities that have some level of distress due to potential long-term liability issues. The most common issues we experience associated with M&A activity are:

- Environmental liability,
- Pending or prior litigation,
- Plugging and abandonment liabilities, and
- Representation and warranties insurance.

Environmental liabilities

In many cases, opportunities for acquisition can have significant potential for known and unknown environmental liabilities such as polluted sites, long-term cleanup problems and site abandonment issues. We can admit we work in a historically messy industry with operations that can have an impact on the environment. To this end, there are ways a company can identify and transfer these risks to an insurance company.

It is no longer necessary to make environmental issues a "make or break" part of the negotiation process. There are insurance programs available that can indemnify the buyer and seller for known and unknown conditions that may exist on production leases and facilities.

Pollution Legal Liability (PLL) helps protect against environmental risks, presenting flexible solutions to regulatory obligations, purchase-and-sale agreement requirements, lender requirements, and board of director's objectives. PLLs can provide environmental insurance coverage for losses from on- or offsite pollution conditions for an owned or operated property, when such conditions are pre-existing and unknown.

Coverage for losses arising from future conditions created during the operation of a facility can also be purchased. Losses from pollution conditions can be triggered by government orders, third-party claims or first-party discovery, any of which can be unpredictable and difficult to quantify in the M&A process.

The PLL suite of products transfers environmental liabilities to the insurance company, helping potential buyers and sellers achieve a level of comfort that conditions and obligations will be satisfied. Each policy can be individually written to match the requirements set forth in the purchase-and-sale agreement, as well as indemnify both buyer and seller.

Cleanup Cost Cap Insurance The CCC insurance policy provides coverage to cap potential and ongoing environmental clean-up costs, therefore mitigating the uncertainty inherent in forecasting pollution remediation costs.

The policy covers the buyers or sellers for cost overruns associated with the clean-up of known contaminants, as well as optional insurance for costs associated with clean-up of newfound contamination at the site. No longer is it necessary to exclude ongoing and potential cleanup projects when considering an opportunity.

Environmental Protection Programs This policy offered by specific insurance carriers is a unique and flexible insur-

ance program that companies can use to manage their environmental liabilities. These policies combine traditional environmental insurance coverages, such as CCC coverage or PLL insurance, with discounted funding techniques for existing liabilities. The EPP is designed to meet specific financial and risk management objectives of the buyer or seller.

Pending and prior litigation

Director and officer concerns, securities litigation, employment practices issues, third-party damage suits and successors liability challenges might crop up to hinder the successful closing of a deal. However, pending and prior litigation insurance enables companies to manage the negative financial impact of a wide range of events, including litigation involving large uninsured and underinsured liabilities and complex operational issues. Such events may impede successful closure of merger and acquisition transactions, hinder value creation, or stand in the way of needed financing.

Pending and prior litigation insurance can be vital to companies encountering the uncertainties associated with material litigation. Some possible uses include:

• Transfer liabilities to an insurance company, enabling the buyer or seller to eliminate operational obstacles and advance growth strategies.

• Cap future financial risk, clearing the way for a buyer or seller to pursue a business or merger and acquisition opportunity previously blocked or impeded by unresolved claims or litigation.

• Quantify the future value of liabilities resulting from third-party claims or litigation, so that these liabilities can be effectively managed.

• May permit public disclosure of an insurance solution for an ongoing litigation exposure. Helps to mitigate potential violations in lending agreements that might result in the loss of impairment of your credit line.

Plugging and abandonment issues

This is the sleeping giant for the oil and gas industry. As U.S. production continues to mature, the issue of P&A liability is not going away. In this vein, many operators who have significant holdings are unwilling and sometimes unable to see clear of divesting their properties due to fears of long-term liability. Faced with this "either-or" decision, many choose to sit on the properties rather than take the risk of divestiture.

But, a program is available that can make a seller more comfortable with a potential buyer. An alternative to a traditional surety approach, it is designed to provide a long-term financial assurance program to support potential P&A financial assurance requirements. Presently, the traditional bond markets can require up to 100% cash collateral on this type of bond. Couple this with the ever-increasing cost of surety— ranging from $12 to $15 per $1,000—can keep buyers away form the properties and sellers holding them. This alternative program can provide a number of specific benefits over the traditional approach, including significant risk transfer and measurable cost savings.

The program is structured to have an insurance policy act as security for the requested P&A bonds. It will provide the current financial assurance along with any increases that may be required over the policy term, provided that the remaining limit of liability of the policy is sufficient to cover the required costs.

The proposed policy will pay the actual P&A costs, subject to the limit of the policy, provided that the bonds have not been drawn. If the bonds are defaulted, then the insurer will pay all P&A costs subject to an overall aggregate limit equal to the face amount of the bonds.

This allows smaller operators to take on larger areas of operations with significant P&A costs, thereby assuring larger sellers that the buyers have the financial capability to provide adequate indemnity.

This program offers a number of specific benefits when compared to a typical bond arrangement in the current surety market. These are outlined here.

The program is designed with the benefit of regulatory risk transfer in mind. The limit of liability on the P&A policy can provide coverage in excess of the current bond requirement. This risk transfer benefit will respond in the event that the actual cost of plugging and abandonment exceeds the anticipated amount due to unexpected conditions or changes in the regulatory requirements.

We can admit we work in a historically messy industry with operations that can have an impact on the environment. There are ways an E&P company can identify and transfer these risks to an insurance company.

Depending on accounting treatment of the premium by tax advisors, some or all of the premium paid may be deducted as an expense.

Funds placed in the Experience Account will earn interest in a tax-deferred environment.

The insured is able to secure a long-term financial assurance program to support the required surety from a AAA-rated company.

The bond rates for the surety will be locked in for the term of the program at the lowest filed rates available.

The Experience Account will be readily available to finance plugging and abandonment as it occurs in the future. This mechanism is easier and provides access to funding more efficiently than a traditional surety-backed by collateral.

In the event a smaller producer would like to take on substantial P&A liability from a major or a large independent,

All of these insurance solutions can take some time to put in place, so the earlier a risk management advisor can join the process, the better the result.

comfortable with the risk of plugging wells. This can work best in those instances where there is a substantial amount of liability with P&A of wells onshore or off.

We see a trend of smaller operators taking on older properties from majors and offshore operators. This is a perfect way to be first in with assurance that the buyer has the ability to meet long-term liabilities, therefore making it easier for sellers to release properties.

Representation and warranties

Representation and warranties insurance protects a buyer or seller from financial losses resulting from inaccurate representations and warranties made in connection with a variety of business transactions, especially mergers and acquisitions. Although this is a relatively new product, each year more companies and their advisors develop a better understanding of how representations and warranties insurance can facilitate transactions and creatively transfer risk.

Recently, for example, we have experienced growing interest in the product from private equity and venture capital firms that are divesting their portfolio companies; bidders in auction situations; financially distressed companies selling assets, divisions or subsidiaries; and individuals and families selling closely held companies.

All of these insurance solutions can take some time to put in place, so the earlier a risk management advisor can join the process, the better the result. One thing is certain: in today's M&A environment, everyone has to be more creative, quick and agile. This will require a change of the rules surrounding buying and selling properties. Remember to take all of your resources with you to the deal. Consult your insurance professionals and allow them to help you to go where others fear to tread.

John Ludwig is a partner in EnRisk Services Inc., an insurance brokerage firm specializing in energy-related risk management and insurance, based in Fort Worth, Texas. He may be contacted at jludwig@enriskservices.com.

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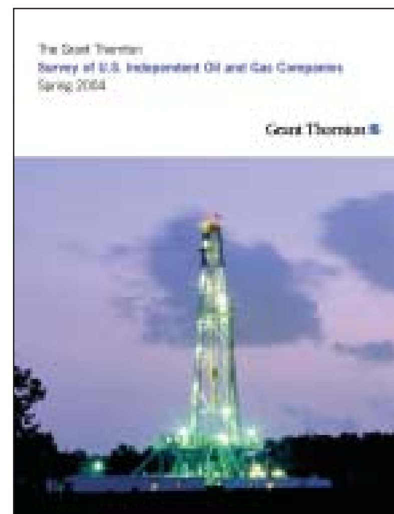

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Beyond Financial Reporting

Energy companies can use Sarbanes-Oxley Section 404 on the operational side, to monitor and fix problems before they show up in the financial results.

ARTICLE BY CHARLES SWANSON AND MARCELA DONADIO

Who would have predicted that significant help in managing risk would come from such an unlikely source as Section 404 of the Sarbanes-Oxley Act? But, by voluntarily extending this model from financial reporting and control to *operational* reporting and control, forward-thinking oil and gas companies may more effectively uncover and manage regulatory and business risks, resulting in increased investor confidence.

The scramble is on: many public companies have staffed up internally and hired outside resources to comply with Section 404. From now until the end of the year, companies will consume much in the way of time, manpower and money documenting, testing and evaluating their internal control structures and procedures for financial reporting. An Ernst & Young survey of 100 major businesses finds that 70% of companies anticipate investing at least 10,000 hours complying with Section 404. Moreover, a survey by Financial Executives International finds that responding companies expect to pay an average of $732,100 for external consulting, software and other assistance to comply.

For most companies with fiscal years ending on or after November 15, 2004, the end product of these significant investments may result in an internal control report from management that accomplishes two key objectives. First, it will help confirm management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting. Second, it will help assess how well the structure and procedures work. The company's external auditors must attest to, and report on, management's assessment.

When it's all said and done, management at most companies will likely breathe a sigh of relief, be glad it's over, put Section 404 activities on the shelf for a while, and move on to more invigorating activities.

However, through our audit and compliance work with energy companies, it has become clear that forward-looking companies should consider taking the logical next step of extending the Section 404 framework from the financial side of the house to the operational side.

Yes, that's right, voluntarily extend Section 404 implementation.

Making the most of your investment

The overwhelming perception most executives have of Sarbanes-Oxley is simply that it is a cumbersome regulatory requirement. But all this compliance has a most definite upside as well. It would be a shame—and a missed opportunity—for companies to make this tremendous investment in Section 404 compliance and not extract additional value from it.

The upside lies in taking the expertise developed in documenting, measuring and testing financial controls and applying it to operations.

The upside lies in taking the expertise developed in documenting, measuring and testing financial controls and applying it to operations.

In many ways, it is no more than the logical next step. We believe that those who translate everything they've learned on the financial side of the house to the operations side will emerge from the 404 process the strongest.

The need for better operational control and reporting has never been greater for energy companies. Regulations have rarely been more complex, the commodity price outlook is hugely uncertain, and the need for experienced operational and executive talent has never been greater. All of these factors, not to mention the capital-intensive nature of the energy business, point to increased need for vigorous risk management practices, policies and procedures.

The dawning of Section 404 financial reporting presents a golden opportunity for management teams to put processes in place that manage risk from its origin—operations. Without thorough operational control, true financial control may be difficult to attain.

In all but the most sophisticated companies, operational controls traditionally have been underdeveloped compared with the financial side. The group most often charged with operational controls, the internal audit team, usually focuses on compliance, instead of the operational issues that ultimately affect financials. This focus on compliance and financial controls will only grow as internal auditors plunge into Section 404 implementation.

In many companies, oversight of operational processes and controls is scattered throughout the organization. More often than not, the job of mandatory operational reporting—to various state and federal energy, health and safety, and environmental regulatory agencies—falls on different

teams in the organization such as human resources. By default, these departments within a company become the keepers of various bits of data and information and report them to regulatory agencies on a regular basis. Because it lacks systemic control, standardized processes, and oversight, this ad hoc reporting style can create significant risks.

As a result, internally driven challenges to what organizations are doing operationally are often non-existent. We see a lot of upward reporting going on, but not a lot of peer review or systematic checks and balances. And it's only through those approaches that gaps can be uncovered and addressed before they create problems.

In many ways, Sarbanes-Oxley is forcing companies to be more forthcoming and expose their financial control risks. However, to truly control financial risks, companies should think about looking even deeper and identify the operational risks from which their financial risks emanate. The principles of Section 404 can give them the tools to do so.

The payoff: fewer surprises

Having stringent operational control and reporting processes in place can alert management to potential trouble spots long before their effects show up in financial statements. There is a very clear and close link between operational and financial reporting. Financial reports are simply a reflection of what has happened in operations.

Unfortunately, management's first look at what happened operationally frequently occurs when the financial statements are produced a month or a quarter later. When the results aren't what they'd expected or hoped for, they then try to fix the problem, and it's too late. In essence, we find that management works backward from the financial statements.

Having operational controls and processes in place, documented and monitored, would serve as an early warning system. This would allow management to address what is happening operationally on a more real-time basis. Long before financial statements are produced, management would recognize that things aren't going as anticipated and take corrective action.

We believe that many of the recent headline-grabbing corporate scandals and failures might have been prevented or mitigated with better operational controls and oversight. With better operational controls, management at these companies could have known early on that they had a fundamental business problem developing and could have acted on it, avoiding all of the tragedy that followed. Unfortunately, they didn't understand what was happening in their companies operationally, and, by the time they discovered it, they didn't have enough time to manage it.

So many risks, so little time

Companies that determine to extend Section 404 beyond financial reporting will immediately be faced with a daunting task: deciding where to start.

Most oil and gas companies face no shortage of operational risks, and there are essentially four ways to address them:

• Insuring them,

• Hedging them,

• Learning to live with them because they don't pose a threat for significant loss, and

• Mitigating them through improved operational and financial controls

Because it's impossible, and probably unnecessary, to address every risk, we suggest using two criteria for identifying those to tackle immediately. First, try to zero in on the critical "handfuls" that pose the most significant potential for loss. Second, consider addressing those that lend themselves to mitigation by improved internal controls. This would include defining and mapping the process as it currently exists, defining what it ideally should look like, and implementing a plan to fill in the gaps.

Internal audit employees are the likely candidates to make suggestions to management for implementing 404-like practices in operations. But to do so, they will need to create a new model for developing, implementing and monitoring operational controls. This is a revamp that is long overdue in most companies. In the future, the internal audit groups that deliver the most value to their organizations will be those that offer innovative solutions to operational control problems.

Though each company faces a unique set of challenges, there are a handful of likely candidates for Section 404-like documentation, review and testing at most oil and gas companies. For example, recent events at several large energy companies have put the issue of reserve estimates in the headlines. Given the decreases in shareholder equity and stock prices that follow asset write-downs resulting from faulty reserve estimates, the process of evaluating and reporting reserves could be a prime candidate for mitigation through improved internal controls at many energy companies. Companies should clearly define the personnel, data and technology involved in calculating these estimates, then test their reliability.

Another operation fraught with uncertainty is the management of seismic, geologic, and engineering data. Energy companies tend to collect enormous amounts of data about their producing fields. Although some companies have standardized processes for continuously updating, interpreting and using this data, we find that most do not. It's a haphazard process at best. A sobering consideration is that such haphazard processes may be driving multi-million dollar capital expenditure decisions.

Who will lead the way?

Because recent business failures and scandals have created an environment that puts internal operational controls under the microscope, it's logical to think that many companies will embrace this idea. But that's not likely to happen.

Managements are so focused on the 404-implementation deadline—and many are so far behind schedule—that they won't deal with the issue of operational controls until another scandal happens.

If Section 404-weary management does not lead the charge to extend this concept to operational controls and reporting, the call for stronger internal controls will likely come from boards of directors, audit committees, investors, rating agencies and other stakeholders.

To date, the investment community has not placed a great deal of emphasis on strong operational controls. But it reacts negatively to financial reporting control failures, often not realizing that these failures usually result from the lack of operational controls. Investors and other constituents of these companies need to be educated about the importance of operational controls so they will begin to place a premium on organizations that are well-managed and have best-in-class operational controls.

The irony is that, for companies consumed with the Section 404 compliance flurry, a promising solution for addressing their operational controls could be right in front of them.

Charles Swanson is Americas director of the Ernst & Young Oil & Gas industry practice. Marcela Donadio leads the energy risk management practice. They are both based in Houston.

Sarbanes-Oxley in a nut shell

Sarbanes Oxley was signed into law July 30, 2002. It consists of Title I through Title XI. It provides a framework requiring many additional rules from the SEC.

Title I: Creates an accounting oversight board supervised by the SEC to regulate audit firms

Title II: Strengthens auditor independence with restrictions on consulting services.

Title III: Strengthens audit committees and requires officer certification of financial statements.

Section 301 makes the audit committee responsible for the auditors, requires that audit committee members be independent, requires that the audit committee have in place procedures for receiving and addressing complaints about accounting, auditing or internal controls including a requirement that allows anonymous submission of concerns, requires funding for audit committees to hire advisors, and designates the entire board as the "audit committee" if a committee isn't designated.

Section 302 requires CEO and CFO certification of financial reports.

Section 303 makes it illegal to coerce, manipulate or mislead the auditors.

Section 304 requires that officers repay certain compensation received during any period of non-compliance.

Section 305 allows the SEC to bar certain individuals from serving as an officer or on the board of a public company if they are "unfit" and allows the SEC to recoup more than compensation received from officers that violated the laws.

Section 306 prohibits insider trading during periods when retirement plan participants can't trade.

Section 307 requires attorneys to notify the board of officer misconduct.

Section 308 makes penalties available to reimburse harmed investors.

Title IV: Disclosures

Section 401 requires material off-balance sheet transactions to be reported in quarterly and annual reports and requires that the SEC issue rules for use of non-GAAP data.

SEC Release 33-8176 includes Regulation G (Reg G) which provides the rules regarding non-GAAP disclosure and the release also requires that all earnings press releases be submitted on Form 8-K. Generally, Reg G Prohibits non-GAAP disclosure that are misleading

Requires that non-GAAP measure be reconciled to the comparable GAAP measure.
(www.sec.gov/rules/final/33-8176.htm) and
(www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm)

Section 402 prohibits officer and director loans.

Section 403 amended Section 16a of the Securities Exchange Act of 1934 to accelerate reporting of insider trades to two days. down from 10+ days. As of July 30, 2003, trades must be reported electronically, the SEC must post filings on the Internet within one day of receipt and companies must post on their website if they have one. This is the Forms 3, 4, & 5 link also called Section 16 filings on the website.

Section 404 requires management assessment of internal control systems. This is the "big thing" auditors are talking about, but assessing internal controls was always supposed to be part of an audit.

Section 405 exempts registered investment companies from some of these rules.

Section 406 requires companies to disclose their officer (CEO, CFO, Controller) code of ethics or why they don't have one in their annual filing. Any change or waiver in the code of ethics must be filed within 5 days in an 8-K or alternatively can be disclosed on their website, if their last 10-K said they would disclose this type of information on the website.

Section 407 requires a company to disclose if it has an expert on the audit committee in the annual filing (10-K).

A financial expert: understands GAAP; can apply GAAP; has experience in/with a comparable company; understands internal controls and understands audit committee functions.

Has relevant experience.

Section 408 requires the SEC to review filings regularly and systematically (at least every 3 years)

Section 409 requires current disclosure in plain English of material changes in financial condition. The SEC can determine how these disclosures should be made.

Title V: Requires the SEC, a registered securities association or national securities exchange to adopt rules designed to address analysts' conflicts of interest.

Title VI: Gives the SEC money to carry out this new law and gives the SEC more authority to enforce its rules.

Title VII: Directs various government agencies to conduct studies and issue reports on topics such as the effect of consolidation of accounting firms, the role of credit rating agencies in the securities markets and other issues.

Title VIII: Address penalties and sentencing guidelines for violation of securities law and creates whistleblower protections.

Title IX: Increase penalties for white collar crime.

Title X: Suggests or requires (?) that the CEO sign the tax return.

TitleXI: Strengthens laws used to prosecute for obstruction of justice (document shredding).

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Ed Fikse,ed.j.fikse@accenture.com, 469-665-5777
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ecgey.com/energy
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Chaim Wachsberger, Partner, cwachsberger@chadbourne.com, 212-408-5100
Laura Brank, Partner, lbrank@chadbourne.com, 7-095-974-2424
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Perry Harris, Business Development Mgr, pharris@lgc.com, 832-200-4795
Ivan Lopez, Business Development Mgr (Brazil), llopez@lgc.com, 55 21 3974 4016
Abdul Hadi Luddin, Business Development Mgr (Malaysia), aluddin@lgc.com, 6 03 2165 2454
Richard Jefferies, Business Development Mgr (U.K.), rjefferies@lgc.com, 44 1372 868764
Mark Brocklehurst, Business Development Mgr (UAE), mbrocklehurst@lgc.com, 971 303 6354

Lee Keeling and Associates
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