Establishing a Joint Interest Audit Program

Today's Speaker

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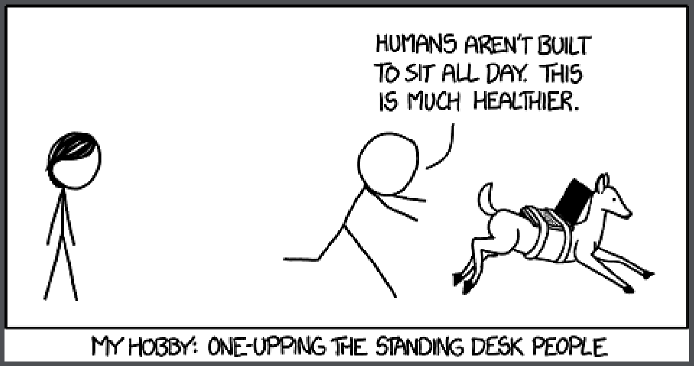
Jody Allred has more than 16 years of experience in public accounting, a deep background in both financial statement audit and advisory services, and a passion for client service.

Jody's current practice emphasis is on internal audit (both outsourced and co-sourced), oil and gas joint interest audit, enterprise risk management, Sarbanes-Oxley (SOX) compliance, business process improvement consulting, service organization controls reporting (SOC), and IT controls. Jody has extensive experience working with clients in the oil and gas (E&P upstream), manufacturing, distribution, health care, construction and high technology products industries.

Discussion Topics

- Defining the joint interest relationship
- Industry drivers of joint interest relationships and conflicting motives
- Managing non-operating investments and third party risk management
- Problem-centric vs. risk management view
- Risk rating your relationships
- Conducting initial assessments
- Building a plan
- Audit types: Expenditure / Revenue
- Recap



All comics from xkcd.com

Defining the Joint Interest Relationship

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Most non-operating partners provide capital to invest in a particular property or group of properties.

The structure is often viewed in the industry as an investment with a projected rate of return based on reserve value.

For risk management purposes it makes more sense to look at them as loans that will be repaid variably based on the cash flows of the investment.

Defining the Joint Interest Relationship

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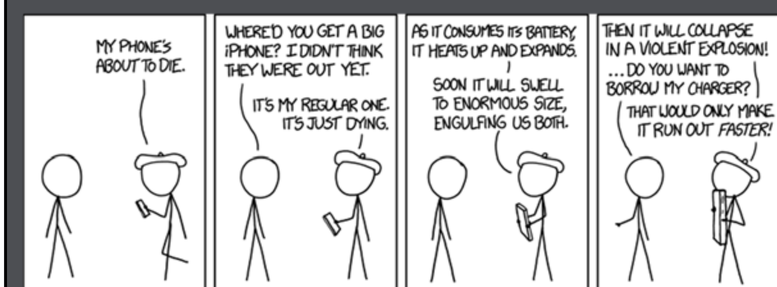
Commercial US Banks – FDIC Statistics on Depository Institutions – Average Assets Size / Loan Value – March 31, 2015

Asset Size Class	<$100M	$100M - $300M	$300M -$500M	$500M - $1B
Average Assets	$58.9M	$178.4M	$385.3M	$702.8M
Average Loan Value	$32.6M	$108.6M	$244.6M	$457.6M

- ***Do you know your total outstanding 'loan' value? What class would your bank be?***
- ***Would a 'loan' view rather than a passive investment view change the way you manage the risk of the 'loan' portfolio?***
- ***Do you think your bank would manage your loan risk the way you manage joint interest investments?***



Industry Drivers of Joint Interest Relationships & Conflicting Motives

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- Industry Drives sharing of:
  - Risk
  - Capital commitment
- Operators and JI Owners have same but opposing motives and pressures; both are focused on achieving high rate of return
- Audits happen when….
  - Data looks unusual (changes) and,
  - Questions are unanswered or,
  - Prices decrease (search for free money – current situation)

Problem-centric v. Risk Management View

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- Traditionally, oil and gas companies have adopted a don't ask, don't tell, problem-centric management approach to non-operated properties. *If there is consistency then things must be **OK, right?.....***

Problem-Centric View	Risk Management View
• Identify underpaid revenue • Identify over charged expenses • Identify denied participation rights	• Effectively respond to third-party risk • Ensure compliance and preempt operator motive • Establish expectation of accountability

Managing Non-Operating Investments and Third-Party Risk Management

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- Third party risk management theory focuses on the following:
  - Reputational risk (Possible relevance)
  - Supply chain risk (No relevance)
  - Compliance / regulatory risk (Possible relevance)
  - Data / information risk (Possible relevance)
  - Dependency / concentration risk (Direct relevance)
  - Competition risk (Direct relevance)
- Establish a portfolio risk assessment

Managing Non-Operating Investments and Third-Party Risk Management

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- Banks risk rate their portfolios

Do you have the information you need to know your exposure?

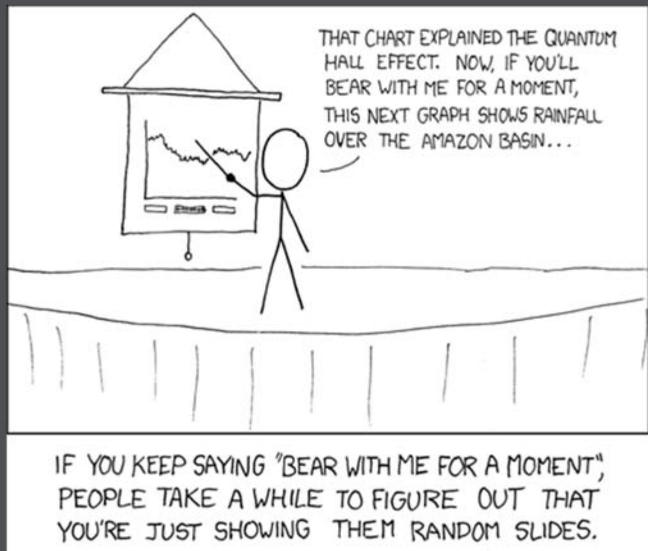
What does their risk management function look like?

Are they likely to sell their operating interest?

What is the credit risk of your joint venture partners?

Are they sufficiently capitalized?

What is the risk of the new operator?



Risk Rating Your Relationships

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- Establishing appropriate responsibility within the organization for managing the joint interest audit program
- Forming risk assessment of non-operating relationships
- Operators and the properties operated will influence the risk rating
- Risk assessment of a joint interest relationship considers the following factors:

Financial significance or materiality → Complex or unique contract terms and revenue arrangements → Operator reputation, history and financial health

Risk Rating Your Relationships

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Operator	Property	Materiality – P/I		Complexity – P/I		Operator – P/I		Average – P/I	
Operator 1	ABC Field	1	1	2	2	2	1	1.67	1.67
Operator 2	123 Field	2	3	3	3	3	2	2.67	2.67
Operator 3	XYZ Field	2	1	2	1	1	1	1.67	1.00
Operator 4	123 Field	2	2	2	2	1	1	1.67	1.67
Operator 1	XYZ Field	1	1	1	1	2	1	1.33	1.00
Operator 2	XYZ Field	2	1	1	2	3	2	2.00	1.67
Operator 3	ABC Field	1	1	2	2	1	1	1.33	1.33
Operator 4	ABC Field	2	2	2	2	1	1	1.67	1.67

P = Probability of Error, I = Impact of Error

Conducting Initial Assessments

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An initial assessment may be the response to the risk assessment or a determination of the scope of the audit. It can include reviewing the following:

- Joint operating and lease agreements
- Capital expenditure over time and compared to similar properties
- Lease operating costs over time and compared to similar properties
- Sales volumes over time and compared to similar properties
- Sales volumes compared to publicly available information
- Prices over time and compared to indices or similar properties
- Prior audits/analyses performed
- Inquiries with operator

Building a Plan

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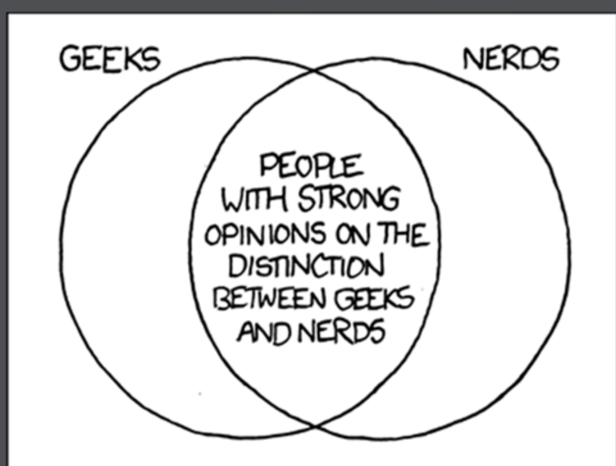
- Build an audit plan based on your risk assessment.

Operator	Property	Risk Rating	Initial Assessment	Audit Type	Date
Operator 1	ABC Field	Moderate	Audit 2015	Expenditure	December
Operator 2	123 Field	High	Audit 2015	Revenue	October
Operator 3	XYZ Field	Low	Audit 2017	Expenditure	December
Operator 4	123 Field	Moderate	Audit 2016	Revenue	February
Operator 1	XYZ Field	Low	Audit 2017	Expenditure	November
Operator 2	XYZ Field	Moderate	Audit 2015	Revenue / Expenditure	November
Operator 3	ABC Field	Low	No Audit	None	None
Operator 4	ABC Field	Moderate	Audit 2016	Expenditure	March



Types of Joint Interest Audits

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Expenditure Audit

Ensure that charges to the joint account are reasonable based on the JOA. Procedures can include the following:

- Ownership review
- Individually significant capital and operating expenditure analysis
- Operator tour report analysis
- Overhead charge reconciliation
- Contract compliance
- Allocation calculation review
- Personnel billing review
- Total cost comparison

Types of Joint Interest Audits

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Revenue Audit

Revenues are reasonable based on the JOA and other governing documents. Procedures can include the following:

- Ownership review
- Process review and documentation
- Sales volumes comparison
- Allocation review
- Market price comparison
- Expense and deduction review
- Royalty calculation review

Recap: Establishing a Joint Interest Audit Program

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QUESTIONS & ANSWERS

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