



Derivative and hedging disclosures:

A survey of select US exploration and production companies on the comparability of derivative and hedging activity following the adoption of SFAS 161

More disclosure: Who benefits?

SFAS 161 has resulted in lengthier disclosures, but is the information useful?

12/31/09 marks the first year end financial reporting cycle where public companies were required to have reported under SFAS 161

Disclosures about Derivative Instruments and Hedging Activities.

Given the additional disclosure requirements for derivatives and hedging activities, Eco+Risk conducted this survey to provide an overview and insight into derivative and hedging practices within the upstream oil & gas industry. While most upstream oil and gas companies use derivative instruments as a means to manage commodity price volatility and the related impact on cash flow and earnings, it is unclear if hedging practices are homogenous across the industry or if the programs are considered successful within their peer group. As such, this study is intended to provide a summary of hedging practices, insight into the structure of hedging programs and compare reported practices against industry norms. We also wanted to assess whether adoption of the new standard improved comparability between companies (i.e. did similar sized companies implement similar hedging strategies, is there consistency regarding the selection and tenor of hedging instruments, etc.)

We conducted our survey in 2 parts:

- 1) A qualitative assessment of derivative and hedging

disclosures with a view towards transparency

- 2) A quantitative comparison of derivative hedging strategy

Sample E&P Companies (Revenue)	
> \$5 billion	4%
3 – 5 billion	2%
1 – 3 billion	13%
< 1 billion	81%

For the first part of the survey, our focus was on financial statement disclosure content describing the intent and limitations of hedging programs. To fully assess the impact SFAS 161 has had on the quality of derivative disclosures, it is important to understand the intentions the Financial Accounting Standards Board (FASB) had in issuing the standard. Based on the input received from financial statement users, the FASB believes that the benefits of adopting SFAS 161 include the following:

a. Financial statements will be more understandable. Users of financial statements will be able to better assess the effect that derivative instruments have on an entity's financial position, financial performance, and cash flows.

b. The comparability of financial statements between entities will be improved in that users of financial statements will be able to compare between entities the overall effect of, reasons for, and effectiveness of using derivatives.

c. Information in the footnotes will be more transparent because the derivative footnote will now include cross-referencing to other footnotes that contain derivative-related information.

In performing our survey, we focused on the areas the FASB hoped to address in issuing SFAS 161; namely improved understanding of management's use of derivatives and the impact on the overall readability of the financial statements. When assessing the financial statements surveyed, we did so from the perspective of an investor or general user of the information contained in the filing. We did not review the filing for compliance with US GAAP or SEC reporting guidance.

The data in this study was sourced predominantly from FYE 12/31/2009 10-K filings accessed through the SEC's EDGAR database. In some cases, publicly available news information was used to compliment the financial statement information (e.g. published articles and news releases). Proprietary information was not used in the creation of this study. Eco+Risk disclaims the accuracy of the data as it originated with the companies under review as opposed to Eco+Risk.

This study is not intended to be completely inclusive. This study is not intended to advocate any particular hedge strategy or lack thereof. The study is also not meant to advocate any particular accounting treatment related to hedging.

What did we find?

We believe SFAS 161 has generally provided greater insight into an individual company's use of derivatives even if you cannot fully understand how they were deployed from a risk management perspective. However, there were two decisions taken by the FASB that limit comparisons between companies. The first was the decision that:

*“Qualitative disclosures about an entity’s objectives and strategies for using derivative instruments may be more meaningful if such objectives and strategies are described in the context of an entity’s overall risk exposures relating to interest rate risk, foreign currency exchange rate risk, commodity price risk, credit risk, and equity price risk. Those additional qualitative disclosures, if made, should include a discussion of those exposures even though the entity does not manage some of those exposures by using derivative instruments. **An entity is encouraged, but not required, to provide such additional qualitative disclosures about those risks and how they are managed.**”*

The second is the Board’s decision not to include presentation within the scope of SFAS 161. The Board decided:

“Addressing presentation as part of the current scope of the project potentially could delay issuing a standard that would improve significantly the transparency of derivative instruments and related hedged items, and their overall effect on an entity’s financial position, results of operations, and cash flows. In addition, various presentation issues related to derivatives and related hedged

*items are being addressed in the Board’s current project on financial statement presentation. **For these reasons, the Board decided that presentation should not be part of the project scope.**”*

We believe that these two decisions significantly impair comparability among companies subject to the standard. Most companies provided a list of their derivative instruments, provided select interpretative guidance surrounding the accounting treatment of derivatives, included some discussion on the risk of deploying derivative instruments and generally complied with recommended presentation of derivative types.

“The company does not hold or issue derivative financial instruments for speculative trading purposes.”

“All of our market risk sensitive instruments were entered into for purposes other than speculative trading.”

Very few companies provided a robust discussion around how derivative use was related to management’s risk tolerance and their overall assessment of market risk. We believe many readers of financial statements are reviewing the derivative and hedging disclosures to make a determination as to whether this activity is truly reducing the company’s exposure to commodity price risk or whether these positions may in fact be magnifying the impact of certain price movements (i.e. is the company using derivatives to speculate in the commodity markets). For E&P

companies with dedicated trading groups, this activity is usually separated from other hedging activity and the impact on the financials is fairly easy to observe and understand. For E&P companies that perform very limited hedging, usually to lock in favorable forward prices over anticipated production, this activity is also fairly easy to assess and understand within the financials. The problem is assessing the derivative and hedging activities of all the companies that fall in between these two groups. These middle companies generally have a more dynamic view towards hedging and rebalance their hedge positions based on management’s fundamental view of market conditions or in response to a significant change in their operating environment. Most companies do not provide much insight into how the selection of the various derivative instruments ties into their assessment and understanding of commodity price risk and its subsequent impact on business strategy. We believe it would most benefit the users of financial statements to have more disclosure around how these companies analyze the market and the decision process they undertake when they adjust their hedge positions. Presently, SFAS 161 only encourages this level of disclosure and does not require it.

Key Observations

Distribution of information

Information on derivative and hedging is still spread widely throughout the 10-K. This is understandable as derivatives impact many areas of the financial statements and management's discussion of their operations and assessment of risk. Most companies contained a discussion on their derivative activity under the following sections of the 10-K:

Item 1 Business

Item 1a Risk Factors

Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations

Item 7a Quantitative and Qualitative Disclosures About Market Risk

Item 8 Financial Statements and Supplementary Data

Notes to Financial Statements - Footnote on Derivatives and Hedging Activity, Footnote on Fair Value Measurement

A few companies did a good job of limiting repetition and cross-referenced between the sections. However, to ensure a complete understanding of all derivatives and hedging activity, the reader is forced to scan the entire 10-K document. In several filings, we observed conflicts between statements made in different sections of the report. For example, several filers stated in an early disclosure that they did not employ hedge accounting (and had no prior year accounting hedges designated), but retained a

discussion of the impact of their hedging program on OCI.

Some companies clearly indicated the percentage of anticipated production that was hedged for the next three years. Other companies simply listed the details of their derivative instruments and it was up to the reader to calculate the percent hedged, if they could find anticipated production data.

One recommendation is for companies to copy all sections of their 10-K that discuss derivative and hedging activity into a separate document. This document could then be reviewed from the perspective of consistency and repetition.

It would be helpful for the reader, if the company disclosed both the hedge instrument details and the anticipated or target production hedged in the same place.

Hedge accounting

73 % of the companies surveyed in our sample no longer elect hedge accounting (this includes interest rate hedging). This number is far higher than we estimated when we began our survey and it would be considerably higher if we ignored interest rate hedging. Most companies cited the operational difficulties and costs of maintaining a hedge accounting program had outweighed the benefit.

Many companies dedicated considerable effort to explaining the requirements of SFAS 133 and the potential impact on the financial statements. Several filers went through this effort even

though they had decided to no longer employ hedge accounting.

We have seen periods in the past of lower commodity price volatility when companies reduced their use of hedge accounting. Companies become comfortable with their ability to either reduce their use of derivative instruments or to explain any volatility contributed to derivative activity to investors and other stakeholders. The real test to this strategy comes during periods of high market volatility especially at or around the quarters. When derivative losses reduce EBITDA by 20 or 30%, key stakeholders generally have a harder time understanding a company's ability to manage volatility.

Inconsistency in presentation

It should come as no surprise, since the FASB did not pursue presentation as part of the project scope, that presentation results varied considerably among filers.

SFAS 161 provides several example disclosures and discusses in detail what should be included in the disclosure. Our review found that many companies did not follow the tabular examples provided within the standard and chose an alternate format. We discussed this with several companies and they stated that they found their alternate format to be easier to use and communicate to senior management within the company.

There are also differences in the tabular presentation of derivatives which makes comparison difficult. Some companies provide aggregate values by instrument type while

others present their results by commodity or risk category. SFAS 161 requires companies to disclose the gross value of derivatives in the footnote. For several companies in the sample, it was difficult to determine if derivatives were reported net or gross. There was also inconsistency in volumetric units and in how derivative positions were aggregated (e.g. by commodity or by risk).

Many companies chose to expand their 7a Disclosure to capture more information on derivative use while others almost eliminated the 7a disclosure altogether and cross-referenced to another section of the filing. Many companies expanded their disclosures around fair value measurement to capture some of the perceived SFAS 161 requirements. Others reduced their fair value measurement disclosure and referenced the enhanced derivative and hedging footnote. The point is that comparison is complicated as the information can be spread widely through the filing.

In our opinion, the guidance around where and how to book derivative gains and losses leaves considerable flexibility to the company. Some companies maintain separate accounts for derivative gains and losses, while others embed these in commodity sales or cost of sales. Some companies provide within the derivative and hedging footnote a breakdown between realized and unrealized gains and losses while others do not. There are also terminology differences i.e. realized vs. settled vs. recognized.

Counterparty credit and collateral

SFAS 161 also enhances disclosure requirements relating to the credit

impacts of derivative and hedging activity. SFAS 161 amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, by requiring disclosure of information about counterparty credit risk including concentrations, maximum potential exposure to credit losses, and the extent to which master netting arrangements potentially reduce the entity's maximum amount of loss due to credit risk. The FASB also amended SFAS 107 to include a footnote clarifying that derivative instruments were included within the scope of financial instruments covered by SFAS 107.

Most companies discussed the potential impact of counterparty credit risk. Usually this was included as a risk within section 1a of their filing or as a discussion point under Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations.

"The Company's counterparties are participants or affiliates of participants in its Credit Facility, which is secured by the Company's oil, natural gas and NGL reserves; therefore, the Company is not required to post any collateral."

Some filers included a stress test under Item 7a. For example 1% increase or decrease in bond yields or credit default swap spreads would impact earnings by x%. There was no observed consistency around the depth of discussion and only a few companies provided some form of analytical or statistical assessment of credit risk.

Several companies discuss the impact of pending OTC legislation on cost of hedging (or availability of

appropriate hedging tools). This is discussed as risk under section 1a or as a potential factor impacting future hedging costs under the derivative footnote.

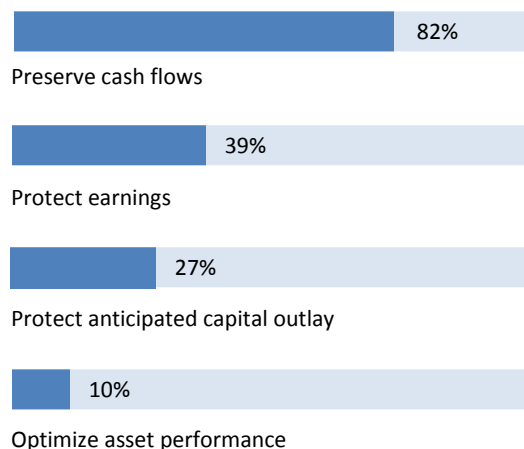
"The adoption of derivatives legislation by Congress could have an adverse impact on our ability to hedge risks associated with our business."

Cross Referencing

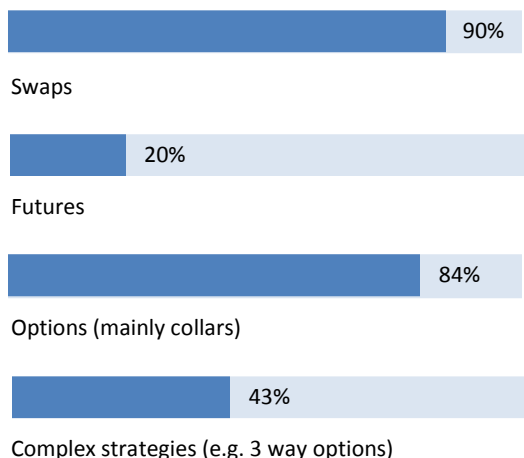
SFAS 161 encourages cross referencing of derivative notes to enhance readability. However, only a few of the filers reviewed effectively cross referenced between the various sections of the filing where derivatives and hedging were discussed.

Derivative and hedging disclosures: summary of results

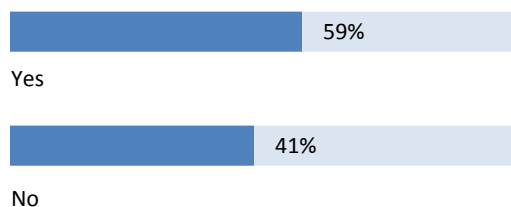
What is the primary purpose of the hedging program?



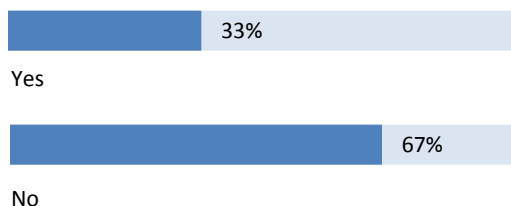
What were the most common derivative instruments used?



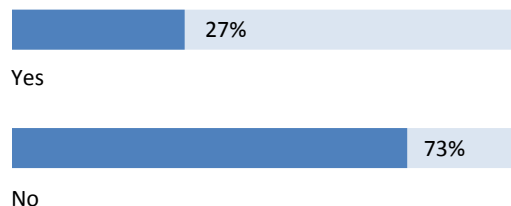
Did the company provide a detailed listing of derivative transactions by instrument type, tenor and volume?



Were basis positions included?



Does the company choose to designate any of its derivatives as accounting hedges under SFAS 133?



Does the company designate space in the filing to explain the accounting literature?



Yes

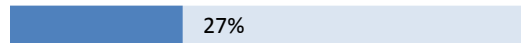


No

Does the company include a statement within the disclosures discussing how hedging protects against unfavorable movements in commodity prices, but may minimize ability to participate in upward market movements? (Usually as a risk in Item 1a)

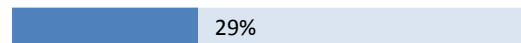


Yes



No

Does the company state that they may adjust hedge positions based on management's assessment of market fundamentals?

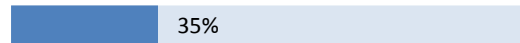


Yes



No

Does the company include a discussion on how hedging may impact collateral?



Yes



No

Did the company state that derivative transactions were conducted primarily with financial entities within the company's credit facility?



Yes



No

"Our decision on the quantity and price at which we choose to hedge our production is based in part on our view of current and future market conditions."