Sanchez Energy Corp
Form 10-K
March 18, 2013

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

(Mark One)

ý **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2012

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to
Commission file number: 1-35372

Sanchez Energy Corporation

(Exact name of registrant as specified in its charter)

Delaware	**45-3090102**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1111 Bagby Street, Suite 1800 **Houston, Texas** (Address of principal executive offices)	**77002** (Zip Code)

(713) 783-8000
(Registrant's telephone number, including area code)

Securities Registered Pursuant to Section 12(b) of the Act:

(Title of Class)	**(Name of Exchange)**
Common Stock, par value $0.01 per share	New York Stock Exchange

Securities Registered Pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No ý

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No ý

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer ý	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No ý

Aggregate market value of the voting and non-voting common equity held by non-affiliates of registrant as of June 30, 2012: $569,169,307

Number of shares of registrant's common stock outstanding as of March 15, 2013: 34,589,698.

Documents Incorporated By Reference:

Portions of the registrant's definitive proxy statement for its 2013 Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission within 120 days of December 31, 2012, are incorporated by reference into Part III of this report for the year ended December 31, 2012.

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We are an "emerging growth company" as defined under the Jumpstart Our Business Startups Act of 2012, commonly referred to as the "JOBS Act". We will remain an "emerging growth company" for up to five years from the date of the completion of our initial public offering, or the IPO, on December 19, 2011, or until the earlier of (1) the last day of the fiscal year in which our total annual gross revenues exceed $1 billion, (2) the date that we become a "large accelerated filer" as defined in Rule 12b-2 under the Securities Exchange Act of 1934, as amended, or the Exchange Act, which would occur if the market value of our common equity that is held by non-affiliates is $700 million or more as of the last business day of our most recently completed second fiscal quarter or (3) the date on which we have issued more than $1 billion in non-convertible debt during the preceding three year period.

As an "emerging growth company", we may take advantage of certain exemptions from various reporting requirements that are applicable to other public companies that are not "emerging growth companies" including, but not limited to:

- not being required to comply with the auditor attestation requirements related to our internal control over financial reporting pursuant to Section 404(b) of the Sarbanes-Oxley Act;
- reduced disclosure obligations regarding executive compensation in our periodic reports and proxy statements; and
- exemptions from the requirements of holding a nonbinding advisory vote on executive compensation and shareholder approval of any golden parachute payments not previously approved.

In addition, Section 107 of the JOBS Act provides that an "emerging growth company" can take advantage of the extended transition period provided in Section 7(a)(2)(B) of the Securities Act of 1933, as amended, or the Securities Act, for complying with new or revised accounting standards. Under this provision, an "emerging growth company" can delay the adoption of certain accounting standards until those standards would otherwise apply to private companies. We have elected to avail ourselves of this exemption from new or revised accounting standards and, therefore, we will not be subject to new or revised accounting standards at the same time as other public companies that are not emerging growth companies.

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains "forward-looking statements" within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical facts, included in this Annual Report on Form 10-K that address activities, events or developments that we expect, believe or anticipate will or may occur in the future are forward-looking statements. These statements are based on certain assumptions we made based on management's experience, perception of historical trends and technical analyses, current conditions, anticipated future developments and other factors believed to be appropriate and reasonable by management. When used in this Annual Report on Form 10-K, words such as "will," "potential," "believe," "estimate," "intend," "expect," "may," "should," "anticipate," "could," "plan," "predict," "project," "profile," "model," "strategy," "future" or their negatives or the statements that include these words, are intended to identify forward-looking statements, although not all forward-looking statements contain such identifying words. In particular, statements, express or implied, concerning our future operating results and returns or our ability to replace or increase reserves, increase production, or generate income or cash flows are forward-looking statements. Forward-looking statements are not guarantees of performance. Although we believe that the expectations reflected in our forward-looking statements are reasonable and are based on reasonable assumptions, no assurance can be given that these assumptions are accurate or that any of these expectations will be achieved (in full or at all) or will prove to have been correct. Important factors that could cause our actual results to differ materially from the expectations reflected in the forward looking statements include, among others:

- our ability to successfully execute our business and financial strategies, including the consummation of the transactions contemplated by the purchase and sale agreement we entered into with Hess Corporation, or Hess, on March 18, 2013 (referred to herein as the "Hess acquisition");
- our ability to replace the reserves we produce through drilling and property acquisitions;
- the realized benefits of the acquisition of SN Marquis LLC, or Marquis LLC, and the proposed Hess acquisition and liabilities assumed in connection with the acquisition and the proposed Hess acquisition;
- the extent to which our drilling plans are successful in economically developing our acreage in, and to produce reserves and achieve anticipated production levels from, our existing and future projects;
- the accuracy of reserve estimates, which by their nature involve the exercise of professional judgment and may therefore be imprecise;
- the extent to which we can optimize reserve recovery and economically develop our plays utilizing horizontal and vertical drilling, advanced completion technologies and hydraulic fracturing;
- our ability to successfully execute our hedging strategy and the resulting realized prices therefrom;
- competition in the oil and natural gas exploration and production industry for employees and other personnel, equipment, materials and services and, related thereto, the availability and cost of employees and other personnel, equipment, materials and services;
- our ability to access the credit and capital markets to obtain financing on terms we deem acceptable, if at all, and to otherwise satisfy our capital expenditure requirements;
- the availability, proximity and capacity of, and costs associated with, gathering, processing, compression and transportation facilities;

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- the timing and extent of changes in prices for, and demand for, crude oil and condensate, natural gas liquids, or NGLs, natural gas and related commodities;

- our ability to compete with other companies in the oil and natural gas industry;

- the impact of, and changes in, government policies, laws and regulations, including tax laws and regulations, environmental laws and regulations relating to air emissions, waste disposal, hydraulic fracturing and access to and use of water, laws and regulations imposing conditions and restrictions on drilling and completion operations and laws and regulations with respect to derivatives and hedging activities;

- developments in oil-producing and natural gas-producing countries;

- our ability to effectively integrate acquired crude oil and natural gas properties into our operations, fully identify existing and potential problems with respect to such properties and accurately estimate reserves, production and costs with respect to such properties;

- the extent to which our crude oil and natural gas properties operated by others are operated successfully and economically;

- the use of competing energy sources and the development of alternative energy sources;

- the extent to which we incur uninsured losses and liabilities or losses and liabilities in excess of our insurance coverage; and

- the other factors described under "Item 1A. Risk Factors" in this Annual Report on Form 10-K and any updates to those factors set forth in our subsequent Quarterly Reports on Form 10-Q or Current Reports on Form 8-K.

In light of these risks, uncertainties and assumptions, the events anticipated by our forward-looking statements may not occur, and, if any of such events do, we may not have correctly anticipated the timing of their occurrence or the extent of their impact on our actual results. Accordingly, you should not place any undue reliance on any of our forward-looking statements. Any forward-looking statement speaks only as of the date on which such statement is made, and we undertake no obligation to correct or update any forward-looking statement, whether as a result of new information, future events or otherwise, except as required by applicable law.

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PART I

Item 1. ***Business***

Overview

Sanchez Energy Corporation (together with our consolidated subsidiaries, the "company," "we," "our," "us" or similar terms) is an independent exploration and production company focused on the exploration, acquisition and development of unconventional oil and natural gas resources in the Eagle Ford Shale in South Texas. As of December 31, 2012, we had accumulated approximately 95,000 net leasehold acres in the oil and condensate, or black oil and volatile oil, windows of the Eagle Ford Shale in Gonzales, Zavala, Frio, Fayette, Lavaca, Atascosa, Webb and DeWitt Counties of South Texas. We have included definitions of some of the oil and natural gas terms used in this Annual Report on Form 10-K in the "Glossary of Selected Oil and Natural Gas Terms."

Our Eagle Ford Shale acreage is comprised of approximately 9,700 net acres in Gonzales County, Texas, which we refer to as our Palmetto area, approximately 28,400 net acres in Zavala and Frio Counties, Texas, which we refer to as our Maverick area, and approximately 57,100 net acres in Fayette, Lavaca, Atascosa, Webb and DeWitt Counties of South Texas, which we refer to as our Marquis area. We own all rights and depths on the majority of our Eagle Ford Shale acreage. We believe this acreage to be prospective for other zones, including the Buda Limestone, Austin Chalk and Pearsall Shale formations that lie above and below the Eagle Ford Shale. We are currently evaluating these other zones, which may present us with additional drilling locations. Several of our existing wells are either producing from or have logged pay in the Buda Limestone and the Austin Chalk formations.

Our estimated proved reserve information as of December 31, 2012 is based on a report prepared by Ryder Scott Company, L.P., or Ryder Scott, our independent reserve engineers. The following table presents summary data for each of our primary project areas as of December 31, 2012 and our capital expenditure budget for the 2013 fiscal year:

		Identified Drilling Locations(1)		2013 Capital Expenditure Budget			
	Net Acreage	Gross	Net	Gross Wells	Net Wells	Drilling Capex (in millions)	Estimated Net Proved Reserves(2) (mmboe)
Palmetto Gonzales(3)	9,670	237	113	25	12.5	$ 125	17.7
Maverick Zavala, Frio	28,436	264	230	2	2.0	12	0.6
Marquis Fayette, Lavaca, Atascosa, Webb and DeWitt	57,076	472	472	19	19.0	190	2.9
Total Eagle Ford Shale	95,182	973	815	46	33.5	327	21.2
Other	83,249	46	11				
Total	178,431	1,019	826	46	33.5	$ 327	21.2

(1) Total identified drilling locations are calculated using approximately 120 acre well-spacing for our Maverick and Marquis areas and approximately 80 acre well-spacing for our Palmetto area in the Eagle Ford.

(2) Based on Ryder Scott estimated proved reserve report as of December 31, 2012.

(3)

In our Palmetto area, we have 106 gross (53 net) locations that are classified as proved undeveloped at December 31, 2012. We plan to drill all of those proved undeveloped locations within the next five years.

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Recent Developments

On March 18, 2013, we executed a definitive agreement to purchase assets in the Eagle Ford Shale in South Texas from Hess for approximately $265 million in cash, subject to customary adjustments. The effective date of the transaction is March 1, 2013 with an expected closing date in the second quarter. The proposed acquisition includes (based on the Company's internal estimates) estimated proved reserves, as of the effective date, of 13.4 mmboe, 70% oil and 30% natural gas. Proved developed reserves are estimated to account for approximately 50% of the total proved reserves. As of the effective date, the properties to be acquired consisted of approximately 43,000 net acres in Dimmit, Frio, LaSalle and Zavala Counties of South Texas with 50 gross wells currently producing approximately 4,500 boe/d.

In connection with the acquisition we have secured commitments for $325 million in debt financing and expect to access the capital markets in the near term, subject to market conditions and other factors. Closing of the acquisition and availability of the debt financing are expected to occur concurrently in the second quarter of this year and will be subject to the satisfaction of various customary closing conditions.

Our History

We are a Delaware corporation formed in August 2011 to explore, acquire and develop unconventional oil and natural gas assets. In December 2011, we completed our IPO and concurrently closed or entered into the following transactions:

Sanchez Energy Partners I, LP, or SEP I (a member of the Sanchez Group (as defined below)), contributed to us 100% of the limited liability company interests in SEP Holdings III, LLC, or SEP Holdings III, which owns interests in unconventional oil and natural gas assets consisting of undeveloped leasehold, proved oil and natural gas reserves and related equipment and other assets. In exchange for the limited liability company interests in SEP Holdings III, we paid SEP I $50 million from the proceeds of the IPO and issued to SEP I 22,090,909 shares of our common stock. As a result of this transaction, SEP I became our largest stockholder at the time, holding approximately 66.9% of our outstanding common stock immediately following the completion of our IPO and the related transactions. On June 19, 2012 and September 17, 2012, SEP I distributed substantially all of the shares that it received in the IPO to its partners.

We acquired 100% of the limited liability company interests in Marquis LLC, which owns unevaluated properties in Fayette, Lavaca, Atascosa, Webb and DeWitt Counties of South Texas. In exchange for the limited liability company interests in Marquis LLC, we paid Ross Exploration, Inc., or Ross Exploration, approximately $89 million in cash from the proceeds of the IPO and issued to Ross Exploration 909,091 shares of our common stock. The acreage that we acquired is subject to an overriding royalty interest that was previously conveyed by Ross Exploration to one of its affiliates.

We entered into a services agreement, or the Services Agreement, and other related agreements with Sanchez Oil & Gas Corporation, or SOG (together with its affiliates (excluding us but including SEP I), collectively referred to as members of the "Sanchez Group"). SOG is headquartered in Houston, Texas and is a private, full service oil and natural gas company engaged in the exploration and development of oil and natural gas primarily in the South Texas and onshore Gulf Coast areas on behalf of its affiliates. Pursuant to the Services Agreement, SOG (directly or through its subsidiaries) agreed to provide us with the services and data that we believe are necessary to manage, operate and grow our business, and we agreed to reimburse SOG for all direct and indirect costs incurred on our behalf. For a discussion of the Services Agreement, please read Note 9 "Related Party Transactions" in the notes to the consolidated

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financial statements in "Item 8. Financial Statements and Supplementary Data" of this Annual Report on Form 10-K.

We refer to the assets that we acquired through our acquisition of the limited liability company interests in SEP Holdings III as the "SEP I Assets" and the assets that we acquired through our acquisition of the limited liability company interests in Marquis LLC as the "Marquis Assets."

Our Business Strategies and Competitive Strengths

Our primary business objective is to increase stockholder value by building reserves, production and cash flows at an attractive return on invested capital. To achieve our objective, we intend to execute the following business strategies:

Aggressively Develop Our Eagle Ford Shale Leasehold Positions. We intend to aggressively drill and develop our acreage position to maximize the value of our resource potential. At December 31, 2012, 82.5% of our reserves were proved undeveloped, or PUD, and the up to 973 gross (815 net) locations for potential future drilling that we have identified in our Eagle Ford Shale area will be our primary targets in the near term. We believe the Eagle Ford Shale to be the highest rate of return project that we currently possess. We anticipate drilling 46 gross (33.5 net) wells through December 2013 with an aggregate drilling and completion capital expenditure budget of approximately $327 million.

Pursue Strategic Acquisitions and Grow Our Leasehold Position in the Eagle Ford Shale and Seek Entry into New Basins. We believe that we will be able to identify and acquire additional acreage and producing assets in the Eagle Ford Shale. By leveraging the Sanchez Group's longstanding relationships in South Texas, we plan on continuing to expand our Eagle Ford Shale acreage position at what we believe to be attractive valuations. We also plan to selectively target additional domestic basins that would allow us to employ our strategies on large undeveloped acreage positions similar to our Eagle Ford Shale acreage.

Leverage our Relationship with Our Affiliates to Expand Unconventional Oil Assets. Various members of the Sanchez Group have drilled or participated in over 900 wells, directly and through joint ventures, and have invested substantial amounts of capital in the oil and natural gas industry since 1972. During this period, they have carefully cultivated their relationships with mineral and surface rights owners in and around our South Texas and onshore Gulf Coast areas and compiled an extensive technological database, which we believe gives us a competitive advantage in acquiring additional leasehold positions in these areas. We have unrestricted access to the proprietary portions of the technological database related to our properties, and SOG is otherwise required to interpret and use the database, to the extent relating to our properties, for our benefit. The majority of the database covers the South Texas and onshore Gulf Coast areas and includes more than 6,400 square miles of 3D seismic data and 47,800 miles of 2D seismic data used for regional interpretation, 435,300 well logs, 16,900 LAS files and 34,900 scanned well documents, as well as a fully integrated suite of the latest interpretive geologic software. We plan on leveraging our affiliates' expertise, industry relationships and size to opportunistically expand reserves and our leasehold positions in the Eagle Ford Shale and other onshore unconventional oil resources.

Enhance Returns by Focusing on Operational and Cost Efficiencies. We are focused on continuous improvement of our operating measures and have significant experience in successfully converting early-stage resource opportunities into cost-efficient development projects. We believe the magnitude and concentration of our acreage within our project areas provide us with the opportunity to capture economies of scale, including the ability to drill multiple wells from a single drilling pad, utilizing centralized production and fluid handling facilities and reducing the time and cost of rig mobilization.

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Adopt and Employ Leading Drilling and Completion Techniques. We are focused on enhancing our drilling and completion techniques to maximize recovery. Industry techniques with respect to drilling and completion have significantly evolved over the last several years, resulting in increased initial production rates and recoverable hydrocarbons per well through the implementation of longer laterals and more tightly spaced fracturing stimulation stages. We continuously evaluate industry drilling results and monitor the results of other operators to improve our operating practices, and we expect our drilling and completion techniques will continue to evolve.

Maintain Substantial Financial Liquidity to Capitalize on Opportunity and Limit Commodity Price Volatility. As of December 31, 2012, we had approximately $50.3 million in cash, $11.6 million invested in available-for-sale securities and no indebtedness. We believe this strong liquidity position, combined with our cash flow from operations and the expected increased borrowing capacity under our credit facilities will allow us to continue to execute a capital expenditure program that should result in steady growth of production and proved reserves.

Core Properties

Eagle Ford Shale

The Eagle Ford Shale is one of the fastest growing unconventional shale trends in North America. According to the Smith Weekly Rig Count, the rig count in the Eagle Ford Shale grew 696% from 28 rigs in January 2010 to 223 rigs as of December 28, 2012. Based on a recent study by the Society of Petroleum Engineers, the aerial extent of the trend is thought to be approximately 11 million acres.

In the Eagle Ford Shale, we have assembled approximately 95,000 net acres with an average working interest of approximately 87%. Using approximately 120 acre well-spacing for our Maverick and Marquis areas and approximately 80 acre well-spacing for our Palmetto area, we believe that there could be up to 973 gross (815 net) locations for potential future drilling on our acreage. We also believe that continued down-spacing in our areas of operation will provide superior recoveries of oil in place and could materially increase our total inventory of drilling locations. Consistent with other operators in this area, we plan to perform multi-stage hydraulic fracturing up to 25 stages on each well depending upon the length of the lateral section. Through December 2013, we plan to spend approximately $327 million on drilling 46 gross (33.5 net) wells on our Eagle Ford Shale acreage.

In our Palmetto area, we have approximately 9,700 net acres in Gonzales County, Texas with an average working interest of approximately 48%. We believe that our Palmetto acreage lies in the volatile oil window where we anticipate drilling, completion and facilities costs on our acreage to be between $7.5 million and $11.0 million per well based on our historical well costs and publicly available information. We have participated in the drilling of 16 gross wells on our acreage that had an average initial 24-hour production rates between 502 and 3,139 boe/d. We have identified up to 237 gross (113 net) locations based on 80 acre well-spacing for potential future drilling in our Palmetto area. We are drilling a five-well pilot program from a single pad to test 40 acre well-spacing in our southern portion of the Palmetto area, and Ryder Scott has given us 80 acre well-spaced PUD locations in the same area in its December 31, 2012 reserve report. Through December 2013, we plan to spend approximately $125 million to drill 25 gross (12.5 net) wells in our Palmetto area.

In our Maverick area, we have approximately 28,400 net operated acres in Zavala and Frio Counties, Texas with an average working interest of approximately 87%. We believe that our Maverick acreage lies in the black oil window, where we anticipate drilling, completion and facilities costs on our acreage to be between $5.5 million and $6.5 million per well based on our historical well costs and publicly available information. We have drilled ten gross horizontal wells that had a range of average initial 24-hour production rates between 214 and 931 boe/d. We have also drilled four vertical wells that had average initial 24-hour rates between 94 and 264 boe/d. We will continue to test the feasibility of a

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vertical well development program and compare horizontal and vertical completion economic returns. We have identified up to 264 gross (230 net) locations based on 120 acre well-spacing for potential future drilling on our Maverick acreage. Through December 2013, we plan to spend approximately $12 million to drill 2 gross (2 net) wells in our Maverick area.

In our Marquis area, we have approximately 57,100 net operated acres, the majority of which are in southwest Fayette and northeast Lavaca Counties, Texas with a 100% working interest. We believe that our Marquis acreage lies in the volatile oil window where we anticipate drilling, completion and facilities costs on our acreage to be between $7.5 million and $11.0 million per well based on our historical well costs and publicly available information. We have drilled three horizontal wells that had a range of average initial 24-hour production rates between 1,114 and 1,369 boe/d. We have identified up to 472 gross and net locations based on 120 acre well-spacing for potential future drilling on our Marquis acreage. We are also drilling a 60 acre well-spacing test in the western Prost area of our Marquis area. Through December 2013, we plan to spend approximately $190 million to drill 19 gross (19 net) wells in our Marquis area.

Other

In addition, we have approximately 1,000 net acres in the Haynesville Shale in Natchitoches Parish, Louisiana, which are operated by Chesapeake Energy Corporation. We do not currently anticipate spending any capital on our Haynesville acreage in the near future. The majority of our Haynesville leases are held by production, giving us and our partners the option to accelerate drilling should natural gas prices increase.

Finally, we have amassed approximately 82,000 net acres in northern Montana, which we believe may be prospective for the Heath, Three Forks and Bakken Shales. Our lease terms in northern Montana are for five years with an option in 2013 to renew for another five years at $10 per acre, giving us time to allow the industry activity to develop the trend before we devote significant drilling capital to our acreage position.

We are continuously evaluating opportunities to grow both our acreage and our producing assets through acquisitions. Our successful acquisition of such assets will depend on both the opportunities and the financing alternatives available to us at the time we consider such opportunities.

Oil and Natural Gas Reserves and Production

Internal Controls

Our estimated reserves at December 31, 2012 were prepared by Ryder Scott, our independent reserve engineers. We expect to continue to have our reserve estimates prepared semi-annually by our independent third-party reserve engineers. Our internal professional staff works closely with Ryder Scott to ensure the integrity, accuracy and timeliness of data that is furnished to them for their reserve estimation process. All of the reserve information maintained in our secure reserve engineering database is provided to the external engineers. In addition, we provide Ryder Scott other pertinent data, such as seismic information, geologic maps, well logs, production tests, material balance calculations, well performance data, operating procedures and relevant economic criteria. We make all requested information, as well as our pertinent personnel, available to the external engineers as part of their evaluation of our reserves.

Technology Used to Establish Reserves

Under the Securities and Exchange Commission, or the SEC, rules, proved reserves are those quantities of oil and natural gas that by analysis of geoscience and engineering data can be estimated with reasonable certainty to be economically producible from a given date forward from known

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reservoirs, and under existing economic conditions, operating methods and government regulations. The term "reasonable certainty" implies a high degree of confidence that the quantities of oil and natural gas actually recovered will equal or exceed the estimate. Reasonable certainty can be established using techniques that have been proven effective by actual production from projects in the same reservoir or an analogous reservoir or by other evidence using reliable technology that establishes reasonable certainty. Reliable technology is a grouping of one or more technologies (including computational methods) that has been field tested and has been demonstrated to provide reasonably certain results with consistency and repeatability in the formation being evaluated or in an analogous formation.

To establish reasonable certainty with respect to our estimated proved reserves, Ryder Scott employed technologies that have been demonstrated to yield results with consistency and repeatability. The technologies and economic data used in the estimation of our reserves include, but are not limited to, electrical logs, radioactivity logs, core analyses, geologic maps and available downhole and production data, seismic data and well test data. Reserves attributable to producing wells with sufficient production history were estimated using appropriate decline curves or other performance relationships. Reserves attributable to producing wells with limited production history and for undeveloped locations were estimated using performance from analogous wells in the surrounding area and geologic data to assess the reservoir continuity. These wells were considered to be analogous based on production performance from the same formation and completion using similar techniques.

See " Estimated Probable and Possible Reserves" for additional information regarding probable and possible reserves.

Qualifications of Responsible Technical Persons

Internal SOG Person. Vinodh Kumar is the technical person primarily responsible for overseeing the preparation of our reserve estimates. Mr. Kumar is also responsible for liaison with and oversight of our third-party reserve engineers. Mr. Kumar has over 40 years of industry experience with positions of increasing responsibility in engineering and evaluations with companies such as Hilcorp Energy Company, El Paso Exploration & Production Company, KCS Energy, Inc. and Koch Industries, Inc. He holds a Masters of Science degree in Petroleum Engineering from the University of Calgary and a Masters of Business Administration from Wichita State University, and he is a Registered Professional Engineer in the State of Texas.

Independent Reserve Engineers. Ryder Scott is an independent oil and natural gas consulting firm. No director, officer or key employee of Ryder Scott has any financial ownership in any member of the Sanchez Group or us. Ryder Scott's compensation for the required investigations and preparation of its report is not contingent upon the results obtained and reported, and Ryder Scott has not performed other work for SOG, SEP I or us that would affect its objectivity. The engineering information presented in Ryder Scott's report was overseen by Don P. Griffin P.E. Mr. Griffin is an experienced reservoir engineer having been a practicing petroleum engineer since 1976. He has more than 30 years of experience in reserves evaluation with Ryder Scott. He has a Bachelor of Science degree in Electrical Engineering from Texas Tech University and is a Registered Professional Engineer in the State of Texas.

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Estimated Proved Reserves

The following table presents the estimated net proved oil and natural gas reserves attributable to our properties and the standardized measure amounts associated with the estimated proved reserves attributable to our properties as of December 31, 2012, based on a reserve report prepared by Ryder Scott, our independent reserve engineers. The standardized measure amounts shown in the table are not intended to represent the current market value of our estimated oil and natural gas reserves.

	As of December 31, 2012
Reserve Data(1):	
Estimated proved reserves:	
Oil (mbo)	18,266
Natural gas liquids (mbbl)	310
Natural gas (mmcf)	15,788
Total estimated proved reserves (mboe)(2)	21,207
Estimated proved developed reserves:	
Oil (mbo)	3,211
Natural gas liquids (mbbl)	99
Natural gas (mmcf)	2,433
Total estimated proved developed reserves (mboe)(2)	3,716
Estimated proved undeveloped reserves:	
Oil (mbo)	15,055
Natural gas liquids (mbbl)	211
Natural gas (mmcf)	13,355
Total estimated proved undeveloped reserves (mboe)(2)	17,491
Standardized Measure (in millions)(1)(3)	$ 286.3

(1) Our estimated net proved reserves and related standardized measure were determined using index prices for oil and natural gas, without giving effect to commodity derivative contracts, held constant throughout the life of our properties. The unweighted arithmetic average first-day-of-the-month prices for the prior twelve months were $94.71/bo for oil, $43.24/bbl for NGLs and $2.76/mmbtu for natural gas at December 31, 2012. These prices were adjusted by lease for quality, transportation fees, geographical differentials, marketing bonuses or deductions and other factors affecting the price realized at the wellhead. As of December 31, 2012, the average realized prices for oil, NGLs and natural gas were $101.40 per bo, $23.26 per bbl and $2.54 per mcf, respectively. For a description of our commodity derivative contracts, please read "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations Costs and Operating Expenses Commodity Derivative Transactions" and "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Estimates Derivative Instruments."

(2) One boe is equal to six mcf of natural gas or one bo of oil or NGLs based on a rough energy equivalency. This is a physical correlation and does not reflect a value or price relationship between the commodities.

(3) Standardized measure is calculated in accordance with Statement of Financial Accounting Standards No. 69, Disclosures About Oil and Gas Producing Activities, as codified in

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Accounting Standards Codification, or ASC, Topic 932, Extractive Activities Oil and Gas. For further information regarding the calculation of the standardized measure, see "Supplementary Information on Oil and Natural Gas Exploration, Development and Production Activities (Unaudited)" included in the financial statements elsewhere in this Annual Report on Form 10-K.

The data in the table above represents estimates only. Oil, NGLs and natural gas reserve engineering is inherently a subjective process of estimating underground accumulations of oil, NGLs and natural gas that cannot be measured exactly. The accuracy of any reserve estimate is a function of the quality of available data and engineering and geological interpretation and judgment. Accordingly, reserve estimates may vary from the quantities of oil, NGLs and natural gas that are ultimately recovered. For a discussion of risks associated with internal reserve estimates, please read "Item 1A. Risk Factors Our estimated reserves and future production rates are based on many assumptions that may prove to be inaccurate. Any material inaccuracies in these reserve estimates or underlying assumptions will materially affect the quantities and present value of our estimated reserves."

Future prices realized for production and costs may vary, perhaps significantly, from the prices and costs assumed for purposes of these estimates. The standardized measure amounts shown above should not be construed as the current market value of our estimated oil and natural gas reserves. The 10% discount factor used to calculate standardized measure, which is required by Financial Accounting Standard Board, or FASB, pronouncements, is not necessarily the most appropriate discount rate. The present value, no matter what discount rate is used, is materially affected by assumptions as to timing of future production, which may prove to be inaccurate.

Development of Proved Undeveloped Reserves

None of our proved undeveloped reserves at December 31, 2012 are scheduled to be developed on a date more than five years from the date the reserves were initially booked as proved undeveloped. Historically, our drilling and development programs were substantially funded from capital contributions, cash flow from operations and the issuance of equity securities. Based on our current expectations of our cash flows and drilling and development programs, which includes drilling of proved undeveloped locations, we believe that we can fund the drilling of our current inventory of proved undeveloped locations and our expansions and extensions in the next five years from our cash on hand combined with cash flow from operations, expected increases to our borrowing capacity under our credit facilities and possible issuance of debt or equity securities. For a more detailed discussion of our liquidity position, please read "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources."

For more information about our historical costs associated with the development of proved undeveloped reserves, please read "Supplementary Information on Oil and Natural Gas Exploration, Development and Production Activities (Unaudited)" included in the financial statements elsewhere in this Annual Report on Form 10-K.

Estimated Probable and Possible Reserves

Unless otherwise specifically identified in this Annual Report on Form 10-K, the summary data with respect to our estimated reserves has been prepared by our independent reserve engineers in accordance with rules and regulations of the SEC applicable to companies involved in oil and natural gas producing activities.

The reserve estimates at December 31, 2012 presented in the table below are based on a report prepared by Ryder Scott, our independent reserve engineers. For more information regarding our independent reserve engineers, please see " Qualifications of Responsible Technical Persons" above.

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The information in the following table does not give any effect to or reflect our commodity derivative instruments.

Estimates of probable reserves are inherently imprecise. When producing an estimate of the amount of oil and natural gas that is recoverable from a particular reservoir, an estimated quantity of probable reserves is an estimate of those additional reserves that are less certain to be recovered than proved reserves but which, together with proved reserves, are as likely as not to be recovered. Estimates of probable reserves are also continually subject to revisions based on production history, results of additional exploration and development, price changes and other factors.

When deterministic methods are used, it is as likely as not that actual remaining quantities recovered will exceed the sum of estimated proved plus probable reserves. When probabilistic methods are used, there should be at least a 50% probability that the actual quantities recovered will equal or exceed the proved plus probable reserves estimates. Probable reserves may be assigned to areas of a reservoir adjacent to proved reserves where data control or interpretations of available data are less certain, even if the interpreted reservoir continuity of structure or productivity does not meet the reasonable certainty criterion. Probable reserves may be assigned to areas that are structurally higher than the proved area if these areas are in communication with the proved reservoir. Probable reserves estimates also include potential incremental quantities associated with a greater percentage recovery of the hydrocarbons in place than assumed for proved reserves.

Estimates of possible reserves are also inherently imprecise. When producing an estimate of the amount of oil and natural gas that is recoverable from a particular reservoir, an estimated quantity of possible reserves is an estimate that might be achieved, but only under more favorable circumstances than are likely. Estimates of possible reserves are also continually subject to revisions based on production history, results of additional exploration and development, price changes and other factors.

When deterministic methods are used, the total quantities ultimately recovered from a project have a low probability of exceeding proved plus probable plus possible reserves. When probabilistic methods are used, there should be at least a 10% probability that the total quantities ultimately recovered will equal or exceed the proved plus probable plus possible reserves estimates. Possible reserves may be assigned to areas of a reservoir adjacent to probable reserve where data control and interpretations of available data are progressively less certain. Frequently, this will be in areas where geoscience and engineering data are unable to define clearly the area and vertical limits of commercial production from the reservoir. Possible reserves also include incremental quantities associated with a greater percentage of recovery of the hydrocarbons in place than the recovery quantities assumed for probable reserves.

Possible reserves may be assigned where geoscience and engineering data identify directly adjacent portions of a reservoir within the same accumulation that may be separated from proved areas by faults with displacement less than formation thickness or other geological discontinuities and that have not been penetrated by a wellbore, and the registrant believes that such adjacent portions are in communication with the known (proved) reservoir. Possible reserves may be assigned to areas that are

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structurally higher or lower than the proved area if these areas are in communication with the proved reservoir.

As of December 31, 2012(1)					
Proved Reserves (mboe)(3)	**PV-10(4) (in millions)**	**Probable Reserves(2) (mboe)(3)**	**PV-10(4) (in millions)**	**Possible Reserves(2) (mboe)(3)**	**PV-10(4) (in millions)**