SEC comment letters focus on borrowing bases, reserves

The latest surveys on SEC comment letters show several E&P companies responding to U.S. Securities and Exchange Commission inquiries on credit facilities, capital resources and petroleum reserves. Besides a recent Ryder Scott survey, Haynes and Boone LLP has done a review on its own, which was presented by **Marc H. Folladori**, senior counsel, at the latest Ryder Scott reserves conference in Houston.

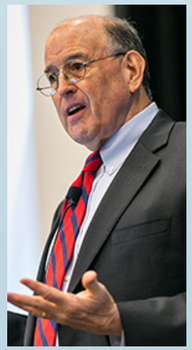
The following comment letter excerpts indicate a growing concern by the SEC about the financial wherewithal of the industry relative to reserves disclosures:

- **Energy XXI Ltd.** on 4/3/15 — If a reduction in your borrowing base is a possibility, address the extent to which it could decrease based on expected oil and gas reserves values and other relevant factors.
- **Clayton Williams Energy Inc.** on 9/16/15 — Are you in compliance with your revised debt covenant? Quantify your current total debt to EBITDAX.
- **Goodrich Petroleum Corp.** on 9/21/15 — Given the reduction in your borrowing base and negative cash flows from operations for six months ended 6/30/15, how did you conclude that you had adequate financing to support the recordation of proved reserves as of 12/31/14? What steps are you taking to avoid or address a covenant breach?
- **Lilis Energy Inc.** on 9/25/15 — What were the terms of the waiver from your lender?
- **Black Hills Corp.** on 9/15/15 — If your credit ratings are downgraded, it appears that you will be required to post additional collateral. Describe the additional collateral posting requirements for you that would likely result.
- **Lonestar Resources U.S. Inc.** on 1/29/16— Do you expect that the drilling of your PUD inventory and expansions and extensions in the next five years will be funded from cash on hand, cash from operations and borrowings under your credit facility?
  - What are the product prices and development/production costs you are assuming for your expectations? What are minimum prices you require to continue your current programs?
  - What is the current level of compliance with your debt covenants? It appears that the current ratio is down from 1.28 at 12/31/14 to 1.09 at 9/30/15.

Noteworthy 2014-2016 Comments by the U.S. SEC

- Development and conversion of PUDs
- Recurring changes in development plans
- Trends and uncertainties resulting from continuing low commodity prices, and the quantification of the impact thereof
- Effects of E&P companies' weaker financial conditions and decreased revenues on their reserves reporting
- Effects of lease expiration on PUD reporting
- Development costs

Folladori's presentation is posted at ryderscott.com/presentations.



Marc Folladori

Uneconomic proved reserves dropped from 2017 SPE-PRMS draft

Reservoir Solutions reported in June that the Society of Petroleum Engineers was considering that uneconomic proved reserves would be allowed to be booked under the 2017 SPE-PRMS if the project's 2P case was economic. That concept met resistance from sister societies involved in drafting of the guidelines, in part, because regulatory agencies, including the U.S. Securities and Exchange Commission, require all reserves to be economic — a hurdle that has become a widely adopted industry standard.

Considering that, the SPE Oil & Gas Reserves Committee dropped its concept of uneconomic and economic proved reserves and redrafted its proposed guidelines so that all reserves categories are required to be economic.

"The OGRC subcommittee had assumed that if the new guidelines revisions were approved, regulators or other parties would have simply added their own requirements that proved reserves be economic," said **Jeffrey Wilson** at the latest Ryder Scott reserves conference in Houston. "However, SPE and its sister societies decided that the concept of uneconomic proves reserves was too big of a change to current industry practices."

The OGRC has been working on a broader definition to accommodate the full range of uncertainty associated with reserves assessments. The committee intended to create a definition set that works in all areas of reserves, not just regulatory requirements.

"Once a project meets commercial criteria based on a best estimate (2P), then all associated resources estimates become classified as reserves, including proved reserves not commercial on their own," said Wilson.

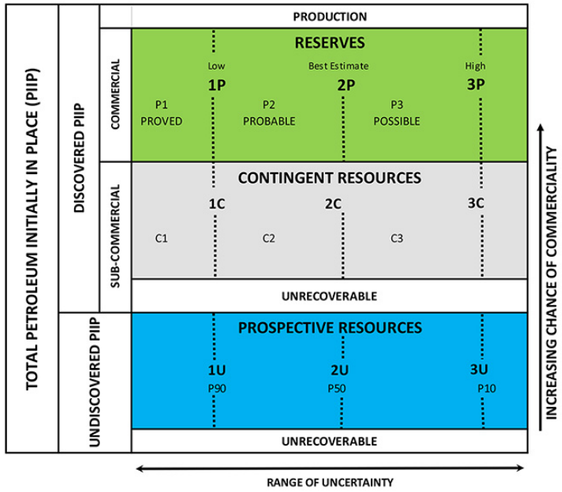
A commercial project has to meet minimum evaluation-decision criterion, such as rate of return, investment payout time, etc. If a project is certain to proceed, the low-side case, in a stochastic study for instance, still has to be represented even if it doesn't overcome initial capital expenditures.

In that situation, resources in the proved or 1P category still have to be "economically producible" as defined by the OGRC when the resource generates revenue that exceeds, or is reasonably expected to exceed, operating costs. Even though the resource may not meet an IRR, if net operating cash flow is positive, then the resource is economic.

Wilson also discussed other SPE-PRMS issues including the following:

- Resource classification framework
- Project maturity sub-classes
- Project definition
- Incremental and cumulative methods
- Clarify risk vs. uncertainty
- Contingent resources movement to reserves and split conditions

Classification Framework



Proposed updates

- Added P1, P2 and P3
- Added C1, C2 and C3
- Prospective Resource with 1U, 2U and 3U ("U" for undiscovered)
- Production box redrawn

Jeff Wilson