News Roundup

SEC may relax reserves reporting rules, says U.S. congressman

Market Watch on June 21 reported that the U.S. Securities and Exchange Commission is considering loosening its rules on producers to allow them to report more reserves. "Current rules limit companies from reporting reserves 'as proved' to those they plan to unearth within five years," wrote **Steve Goldstein**, D.C. bureau chief.

He reported that Rep. **Frank Lucas**, a Republican from Oklahoma, asked SEC Chairman **Jay Clayton** whether the five-year rule still makes sense considering the shale revolution.

"This has been the policy since 2008," Clayton reportedly said. "At that time, shale accounted for a much smaller percentage of oil and gas production than it does now, and I would suggest to you that this five-year rule might not reflect the realities of the new American energy landscape."

Clayton said the agency was considering a rewrite of the rule, wrote Goldstein, quoting the chairman as saying, "I'm concerned in this space that the way our rules require disclosure is inconsistent with the way investors value these companies. So they are looking for additional disclosures, and we should make sure that our rules line up with what investors think is the material information."

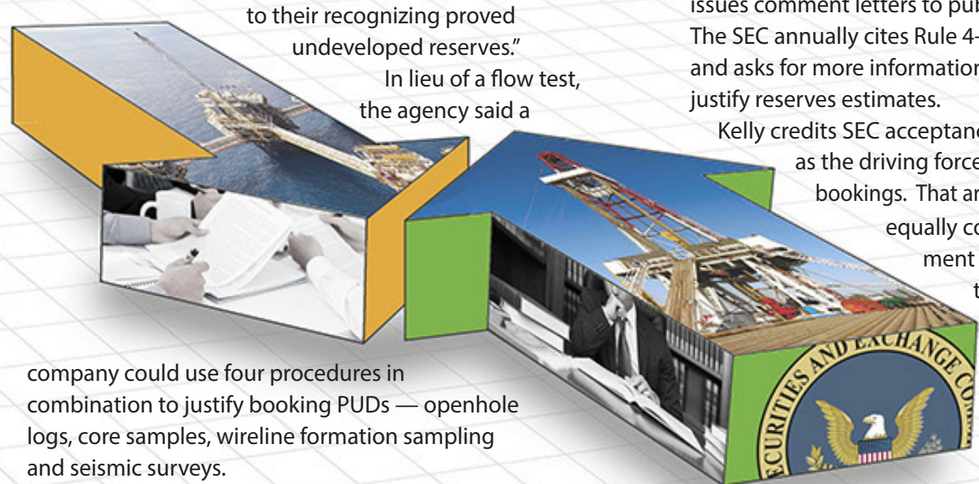
Shale producers are overestimating proved reserves, says blog

A Vancouver-based blog site, *DeSmog Blog*, claims that rules of the U.S. Securities and Exchange Commission have made it easier for public companies with drilling rights in shale plays to inflate proved undeveloped reserves. "… Drillers can count all of the oil and gas they expect to pump out over the well's entire lifetime — before they've found out how fast that well flows or seen a single drop of oil from it," wrote **Sharon Kelly**, a freelance reporter.

Her article is posted at https://www.desmogblog.com/2018/06/14/proved-undeveloped-reserves-sec-rule-change-risks-shale-fracking-pipelines.

Kelly marks 2008 as a turning point for looser SEC rules, specifically in regard to the agency scrapping the flow test as a requirement for justifying reserves as proved. The SEC actually nixed the flow-test requirement four years earlier, as reported by *Reservoir Solutions* in June 2004. At that time, companies drilling in the deepwater Gulf of Mexico (GOM) asked the SEC to do away with the requirement, saying it was too costly and environmentally risky.

The SEC agreed. **H. Roger Schwall**, then an SEC assistant director, told a Houston crowd at a local forum that "after considering responses (from GOM offshore industry), we were able to reach a position of not objecting to their recognizing proved undeveloped reserves."



In lieu of a flow test, the agency said a company could use four procedures in combination to justify booking PUDs — openhole logs, core samples, wireline formation sampling and seismic surveys.

Schwall formalized his comments a day later on an SEC website posting, "Letter to Companies with Oil and Gas Operations in the Gulf of Mexico (GOM)." The SEC reaffirmed that the flow-testing exception applied to the GOM only, so it had no effect on shale reserves.

Reliable technology

Kelly wrote that companies in 2009, after the 2008 "modernization" of the SEC rules, were able to replace the flow test with new technologies. "As long as a company considered those technologies reliably able to predict whether oil and gas could be pumped, the SEC would be satisfied," she stated.

First of all, the SEC didn't replace the flow test with new technologies in its 2008 rules revisions. Secondly, the SEC doesn't defer to industry; it regulates industry. The watchdog agency has criteria for acceptable use of "reliable technology." It has to be "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."

So the burden of establishing and documenting the technology is on the producer.

Secondly, producers don't always "satisfy" the SEC in their filings. To complete some of its reviews, the agency issues comment letters to public oil and gas companies. The SEC annually cites Rule 4-10 (a) (25) of regulation S-X, and asks for more information on technologies used to justify reserves estimates.

Kelly credits SEC acceptance of field-tested technology as the driving force behind increased PUD bookings. That arguably may be the case, but an equally compelling or stronger argument can be made that abolishing the one-offset rule provided more booking flexibility for producers in the shale. That rule allowed PUDs to be booked in drilling locations beyond immediate offsets (legal well spacing requirements) if the reasonable certainty criterion was met.

Kelly also asserts that lenders "turned a blind eye" to reserves values when prices dropped and continued to stay "lower for longer." She cited a September 2017 article by **Laura Freeman** in the *Oil & Gas Financial Journal* to support this contention.

"In 2015, after oil prices slumped, drillers started claiming that their as-yet-undrilled wells (those in the proved undeveloped reserves category) would have higher initial production rates and last longer, resulting in higher total production — even though nothing changed about the physical assets — which let them add proved reserves to their books, the *Journal* reported.

That point is valid if tempered with the fact that industry has recognized that learning curves and associated step changes in drilling and completions have increased production and reserves despite unchanged physical assets.

Banking, bankruptcies and bailouts

Eventually, "drillers had to write down billions of barrels of proved reserves in what *Bloomberg* called a 'puff of accounting smoke,'" quoted Kelly.

Generally, banks routinely review borrowing bases for their loans, making sure they are covered by enough collateral (reserves), she wrote. However, loan agreements are not ironclad when financial disasters strike.

Kelly cited the *Journal* article, which stated, "… despite a 75 percent contraction in oil prices from 2014 to 2016, many of these loans were not reduced in 2015, 2016 or 2017." Kelly said that banks bailed out the companies, for example, by cutting interest rates.

The oil and gas sector owes more than $833 billion to lenders, a May 31 analysis by *Reuters* found, and nearly half of that — roughly $400 billion — is due to be paid off or refinanced by the end of 2019, *DeSmog Blog* republished.

"That means banks and drillers will be re-negotiating hundreds of billions of dollars in loans relatively soon," Kelly stated.

Those renegotiations are poised to cause some repercussions in the industry. A June 26 advisory, "Next Stop: The Twilight Zone. Enforceability of OCC Reserve-Based Lending (RBL) Guidelines," from Haynes and Boone LLC, examines two-year-old guidelines of the E&P Handbook published by the U.S. Office of the Comptroller of the Currency (OCC). They have already prompted some banks to downgrade loans based on a new "total debt" analysis.

As to why banks did not hemorrhage more during the spate of oil and gas bankruptcies, "a few of the senior bank loans also suffered losses, but on balance, losses attributable to RBL were very low, in large part, because the junior debt acted as a heat shield that protected the first lien RBL banks from the meteoric collapse in energy prices," wrote **Buddy Clark**, co-chair of the Haynes Boone energy

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