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Developments (2011-2013) in SEC staff views of E&P companies' oil and gas reserves disclosures

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Overview

- Securities and Exchange Commission (SEC) oil & gas reserves disclosure rules – amended in 2008
- Views expressed by SEC staff on companies' compliance with the amended rules – comment letters issued:
 - 2010 to 2011
 - 2011 to 2013
- Compliance & Disclosure Interpretations (CDIs) — May 2013 addition
- Dodd-Frank extractive resources disclosure rule vacated; however, Dodd-Frank conflicts minerals rule was upheld

Development of SEC rules and US accounting rules on oil and gas reserves disclosures

- Before 1978, no reserves disclosure rules *per se*
- In response to oil crisis and 1973-74 oil embargo, US Congress in 1975 directed SEC to develop accounting standards to disclose reserves of E&P companies
 - “Reserve recognition accounting” concept - abandoned
- From 1977-1982, SEC and FASB worked out full cost and successful efforts accounting methods and supplemental oil & gas disclosure rules - resulted in basic regime for today’s O&G disclosure standards
- Rules amended in 2008, effective in December 2009

SEC's amended rules

- Principal changes to former rules:
 - Use a 12-month *average* price, not the year-end price, per unit of production in determining economic producibility
 - Include hydrocarbons from unconventional/non-traditional sources (*e.g.*, bitumen, synthetic oil, oil sands, etc.)
 - The “reasonable certainty” test (used to estimate the economic producibility of hydrocarbons in order to be classified as proved reserves) was revised to conform to the Petroleum Resources Management System (PRMS) standard
 - Less stringent test applied to establish PUDs beyond one offsetting drilling unit

SEC's amended rules

- Principal changes to former rules (continued):
 - “5-year rule” for booking and maintaining booking of PUDs
 - Undeveloped reserves may be attributed to undrilled locations if an adopted development plan indicates that such locations will be drilled within 5 years—unless *specific circumstances* justify longer time
 - PRMS guidelines: 5 years is benchmark for reasonable timeframe to initiate the development of reserves, although timeframe depends on the specific circumstances
 - New definition - “reliable technology” - broadened types of technologies that could be employed to establish reserves
 - Disclosure of probable/possible reserves permitted
 - 3P engineers’ reports must be filed with annual reports

Companies' experience with amended rules

- First round of staff comment letters were issued in 2010-11 with respect to annual reports for fye 12/31/09
 - For first year's filings, staff principally focused on *whether* companies were complying with amended rules
- Second round (2011-12) – for annual reports for fye 12/31/10; and third round (2012-13) – for annual reports for fye 12/31/11 (and a few annual reports for fye 12/31/12):
 - Comments centered more on *how* companies were complying

Comparison of staff comments in 2010-11 compared to comments in 2011-2013

- Many 2011-13 comments dealt with developing PUDs
- Comments requesting information about granular engineering items in 2011-13
 - E.g., requests for spreadsheets on engineering/costs data
- Many more financial and accounting comments
- Comments reflecting lower natural gas & NGL prices
- More comments relating to foreign issuers, IPOs, MLPs
- Comments dealing with hydraulic fracturing activities
- Comments stimulated by requests from legislators, others

Observations – the 5-year rule

- Staff has maintained a strong presumption against booking:
 - New PUDs that are unlikely to be drilled within 5 years; and
 - PUDs that have remained on books for more than 5 years
- In either case, PUDs should be de-classified as such, unless “specific circumstances” justify a longer time
- Any extension beyond 5 years should be exception - not rule
- What are “specific circumstances” to justify longer time?
 - Determination must take into account all facts and circumstances
 - Examples of situations that *might* justify longer time period: projects involving construction of offshore platforms; development in remote locations, urban locations or environmentally sensitive areas

Observations – the 5-year rule and “specific circumstances”

- Factors to consider in justifying bookings > 5 years:
 - Level of ongoing significant activities in development area
 - Company’s historical record at completing development of comparable long-term projects
 - The amount of time the company has maintained the leases or booked the reserves without significant development activities
 - Extent to which the company has followed a previously adopted development plan (*e.g.*, changes without implementation)
 - Extent to which delays in development are due to external factors (*e.g.*, restrictions on development on federal lands), instead of internal factors (*e.g.*, reallocating development resources to higher-priority properties)

Observations – the 5-year rule

- *Development plan* must have been adopted for reserves to be classified as “undeveloped oil and gas reserves”
- The mere *intent* to develop, without more, does not constitute adoption of a development plan, and would not by itself justify recognition of reserves
- Adoption of a development plan requires a *final investment decision* indicating undrilled locations are scheduled to be drilled within 5 years, unless specific circumstances justify longer time period
 - “Scheduled to be drilled” means the same as PRMS “initiation of development”

Observations – the 5-year rule

- Companies arguing for booking PUDs for > 5 years prompted many extensive staff requests for backup
 - Details on development plans, drilling schedules & project costs
 - Mathematical (%) unlikelihood of converting all PUDs in 5 years
 - Company’s historical rates of conversion of PUDs to PDs would not support estimates
 - Apparent lack of liquidity and financing resources to carry out development program
 - Limited access to fracking services was not an external factor that was “outside the control” of the company
 - Effects on PUDs where drilling program was curtailed due to decreased natural gas prices

Observations – progress in converting PUDs to PDs

- Disclosure is required regarding PUD quantities:
 - Material changes in PUDs, including PUDs converted to PDs;
 - Investments, progress made during year to convert PUDs to PDs, including capital expenditures; and
 - Explanation of why material amounts of PUDs in individual fields or countries remained undeveloped for 5 years or more
- Material changes in PUDs require enhanced disclosures
 - Information should be furnished separately on conversions, discoveries, extensions, divestments, acquisitions, revisions of prior estimates and results from improved recovery activities
 - Disclose capital costs expended to convert PUDs to PDs

CDI Question 106.1 – developed Oil & gas reserves definition

- Before 2008, reserves booked from improved recovery techniques (*e.g.*, fluid injection) to increase EURs could be classified as PDs only if a production response resulted
- Amended definition for developed reserves applies to developed reserves of all categories, and no longer requires production response to be deemed “developed”
- CDI 106.01: if all \$’s have been expended to install or implement the improved recovery technique, but production response is not yet achieved, reserves can still be classified as PDs so long as criteria for “proved reserves” and “developed reserves” are met

Observations – production and development information

- Present activities and trends in development of prospects
 - Situations where crude oil reserve quantities appear to represent a declining portion of total proved reserves
 - Separate production quantities, average sales prices and average production costs per unit of production of oil from:
 - Production quantities, average sales prices (including transfer prices) and average production costs for (i) bitumen and (ii) natural gas liquids (NGLs)
 - Deficiencies in disclosures of production from fields/countries that contain $\geq 15\%$ of a company's total proved reserves
 - Requests for information on trends in development activities/costs, production costs and sale prices

Observations – “reliable technology”

- Defined as a grouping of 1 or more technologies (including computational methods) that have been *field tested* and *demonstrated* to provide *reasonably certain* results with *consistency and repeatability* in the *formation being evaluated* or in an *analogous formation*
 - No other definition provided – company has burden of establishing and documenting the technology(ies) that provide reliable results, consistent with the definition
 - Upon request from the staff, information on a company’s reliable technology should be provided in support of any reserves estimates then under review

Observations – “reliable technology”

- Expanded disclosures on technologies and methods used
 - Particularly where additions to proved reserves estimates were disclosed as being based on use of reliable technology
 - Software program indicating average well life of PUD locations beyond 5 years was not adequate evidence of reasonable certainty — especially where no analogy existed for estimated life of producing wells
 - General descriptions (*e.g.*, “microseismic operations and reservoir simulation modeling”) were not adequate
 - Companies were required to describe and discuss generally the technology, and explain the methods used in applying the technology
 - What were actual technologies used, were they reliable in the geological environments applied, did company also use other technology/methods (such as production flow tests)?

Observations – changes in estimates; revisions of proved reserves

- Changes in estimates/revisions of reserves year-to-year
 - Significant revisions required explanation – were there any major discoveries, other favorable events? Or decisions to curtail development efforts in certain fields or areas? Or declines in hydrocarbon prices during the year?
 - Downward revisions due to production performance required extensive disclosures, including the steps the company was taking to avoid further downward revisions
 - Property acquisitions prompted comments/requests for further information (*e.g.*, where large amount of PUDs had been assigned to properties purchased during year from 3rd party)

Observations – financial and accounting comments

- Additional disclosure concerning various costs and prices
 - Comments in 2012-13 about costs/prices applied to calculate standardized measure of discounted future net cash flows
 - Do not combine abandonment costs with production costs
 - Unless they are insignificant, report future estimated development costs separately from future estimated production costs
 - Funds spent drilling unproved properties aren't development costs
 - Reasons for price differentials for natural gas
 - Enhanced explanations requested on how companies categorized various types of capitalized costs
 - Unless reserves attributed to PUDs were insignificant, report costs of PD properties separately from costs of PUD properties
 - Include costs of gathering systems as development costs?

Observations – financial and accounting comments

- Questions about actual and potential impairments
 - Popular topics: ceiling tests, impairment analysis, identification of asset groups, assumptions for companies using successful efforts method (expected future price and cost changes, appropriate discount rate, adjustments for taxes, etc.)
- Non-GAAP financial measures
 - E.g., “EBITDAX,” “field level segment operating earnings,” etc.

Observations – engineering information

- Engineering information and engineers' reports
 - Clarifying whether report was a “review” or “audit”
 - Deficiencies in the disclosures required to appear in reports
 - Deficiencies in disclosure of principles/standards followed
 - Requests for “supplemental information” – spreadsheets, summary income forecasts for proved reserves, individual income forecasts and exhibits (*e.g.*, maps, volumetric calculations, decline parameters, etc.)
 - Inconsistencies between company's estimates and the report
 - References to “boilerplate” reserve methodologies rather than to the actual methodology applied in estimating reserves

Observations – hydraulic fracturing and pollution

- Hydraulic fracturing activities and related liabilities – requests for additional disclosures/information
 - Specific disclosures of operational and financial risks (*e.g.*, potential underground migration, surface spillage, mishandling of fluids, contents of and chemical additives to fracking fluids, wastewater disposal)
 - Disclosures on potential liabilities for contamination, contractual indemnification obligations, insurance coverage and limits, environmental impact from operations and risks associated with state and federal fracking regulations
 - Enhanced disclosures about pollution risks, potential liabilities and risks, etc., were also requested from offshore producers and drilling companies

Observations – miscellaneous

- Other topics
 - Companies' operations in Iraq, Iran, Syria and Sudan
 - Cash and investments held by foreign subsidiaries
 - Cyber attacks
 - Leases/concessions having PUDs that will expire soon
 - Volumetric production payments, marketing and derivative contracts that covered most of a company's production
 - “Probables” and “possibles” disclosures
 - Internal controls and persons overseeing estimation process
 - Required governmental approvals (environmental, construction, etc.), and when the approvals were expected

Dodd-Frank §1504 Extractive Resources Disclosure Rule vacated by US federal court – July 2, 2013

- Rule 13q-1 adopted in 2012 requiring resource extraction issuers (oil, gas, mining companies) to disclose certain payments made to the US or foreign governments
- Similar to Extractive Industries Transparency Initiative
- Court ruled against SEC, finding:
 - Nothing in §1504 required that there be public disclosure of full resource extraction payments reports – instead, statute refers to a public *compilation* of the payments information that must be made public “to the extent practicable”
 - The SEC did not provide any exemption for disclosure of resource extraction payments made to governments in countries where that disclosure is prohibited