

SEC HOT-BUTTON TOPICS – RESERVES DISCLOSURES

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Ryder Scott 2014 Reserves Conference
September 17, 2014

Overview

- December 2008 - SEC amended its oil & gas disclosure rules (Regulations S-X and S-K)
 - First effective for annual reports/registration statements for companies' fiscal years ended December 31, 2009
- Applicable accounting rules amended in 2010
- Comment letters: views expressed in correspondence by staff on companies' compliance with amended rules
 - Letters issued to date: broken down into 4 periods for review purposes: (i) 2010 – mid-2011; (ii) mid-2011 – mid-2012; (iii) mid-2012 – mid-2013; and (iv) mid-2013 – mid-2014
- Compliance & Disclosure Interpretations (CDIs) issued in October 2009 — two additional CDIs added in 2013

Observations: 2013-2014 Comments

- Higher volume of comment letters issued by staff
- More IPOs in 2013-14
- More comments on disclosures in filings by MLPs
- Comparisons of current disclosures to those in prior filings
- Comments on press releases, website presentations
- More probable and possible reserves disclosures
- Development of PUDs
- Changes in reserves
- Granular accounting comments, particularly on costs
 - Standardized measure for discounted future net cash flows (SM)
 - Capitalized costs for purposes of ceiling and impairment tests
- Disclosure of NGLs separately from oil and natural gas

Development of PUDs

- PUDs development and five-year rule
 - “2013 drilling will be limited to holding acreage” – staff: confirm that your company’s PUDs will be developed in 5 years
 - “We do not have a *material* amount of PUDs that have remained undeveloped for 5 years or more” – staff: disclosure not compliant
 - Recent rate of PUD development (converting PUDs to PDs) did not support position that all PUDs would be developed in 5 years
 - “Special circumstances” exception from 5-year rule
- Uncertainties regarding PUDs
 - Wells drilled in locations not serviced by sufficient gathering or transportation infrastructure – what is the impact that insufficient infrastructure may have on development of existing PUD locations?
 - Governmental approvals

Development of PUDs

- WPX Energy 10-K fye 12/31/12: “We have reduced our quantity of PUDs to be developed in 2013” – staff: disclose progress made during 2013 in converting your as-of-12/31/12 PUDs, including drilling results/delays
 - Has previously-adopted development plan been amended? To what extent were (i) wells drilled according to revised schedule or (ii) any locations removed from your proved reserves?
- Explain differences between your historical and projected unit development costs for development of PUDs
- What are plans for PUD locations that will generate future net revenue but have negative present net worth?
- What are reasons for your reduced conversion rate in 2012 & the reduced projected conversion rates for next 5 years?

Expiring Undeveloped Acreage

- Soon-to-expire leases/concessions and effect on PUDs assigned to locations to be drilled after expiration dates
- How will you address extension of your legal rights to the lease? By paying delay rentals?; are they available?; are they material? By drilling & producing to hold the lease?
 - Disclose quantities of PUDs attributable to locations in expiring acreage, your progress to convert the PUDs - are all these PUD locations included in a management-adopted development plan indicating that the locations will be drilled prior to expiration?
- Provide explanation where important economic factors or significant uncertainties affect particular components of a company's proved reserves – FASB ASC 932-235-50-10

Separate Product Types (NGLs, Etc.)

- Where applicable, separate disclosures are required for natural gas liquids (NGLs)
 - FASB ASC 932-235-50-4 & -5: If “significant,” net quantities of interests in PD and PUD NGL reserves must be disclosed separately and not aggregated with other categories (*i.e.*, crude oil)
 - Reg S-K §1204(a): NGLs are considered to be a “final product” - production must be disclosed on basis of each final product sold
 - Reg S-K §1203(b): Disclose separately (i) average sales price per unit produced & (ii) average production cost per unit of production
- “Liquids” is not considered a separate product type
- Does your presentation of daily net production of natural gas and average price sales of natural gas exclude amounts used for internal consumption?

Reliable Technologies Used to Establish Appropriate Level of Certainty

- Explain extent to which booking of significant additional reserves is supported by 1 or more reliable technologies
- Particularly for PUD locations that are more than one direct offset away from a producing well
 - Quantify number of PUD locations and associated net reserves added that are more than 1 direct offset away from a producing well
 - Any of the wells drilled to date that were more than 1 direct offset away from a producing well determined to be non-commercial?
- If unproved (probable or possible) reserves are disclosed, must also provide general discussion of technologies used to establish appropriate level of certainty of estimates
- Detailed supplemental information sometimes requested

Changes in Proved Reserves

- FASB ASC ¶ 932-235-50-4 and -5
 - Must disclose (i) net quantities of proved reserves, PDs and PUDs as of the beginning and end of each year and (ii) changes in proved reserves during the year
 - The particular causes of the changes must be shown separately along with an appropriate explanation of significant changes
- Disaggregate changes attributable to 2 or more separate causes
- Reg S-K §1203
 - Must (i) disclose material changes in PUDs that occurred during the year (including PUDs converted into PDs), and (ii) discuss the investments and progress made during the year to convert PUDs to PDs, including capital expenditures

Changes in Proved Reserves

- Insufficient reasons given for revisions – if due to well performance, clarify reasons for performance revisions – were revisions concentrated in a few wells or spread across all proved reserves?
- Company disclosed increases to PUDs during fiscal 2012 partially due to restoration of reserves to PUD status that had been previously reclassified to probable reserve status
 - Staff requested information about change in circumstances leading to initial move of the PUDs to probable status & how company concluded that expected ROR was sufficient to restore the PUDs
- Staff often requested a tabular quantitative reconciliation of the overall changes in PUDs

Reserves - Miscellaneous

- Disclosures not compliant with Instruction to Reg. S-K §1202
 - USGS assessment – “estimated mean undiscovered technically recoverable reserves of 599 million bbls of oil and 19 tcf of natural gas”
- Company owned mineral-interest-only acreage operated by a third party – staff: must establish reasonable certainty for PUD reserves booked on this and other non-operated acreage
- Prior conveyances of net profits interests & production payments – were any of company’s proved reserves attributable to the net profits interest or production payment?
- Change in reserve quantities attributable to company’s signing gas processing agreements – should change be classified as a revision or as the result of improved recovery, instead of an extension or discovery?

Probable and Possible Reserves

- More disclosures of unproved reserves in filings – companies often failed to disclose all matters required by Regulation S-K concerning probable & possible reserves
- Discuss the uncertainty related to estimates of probable & possible reserves - explain their relevance to disclosures
- Probable & possible reserves disclosures should not be in the financial statements or notes to financials - whether as supplemental oil & gas information or otherwise
- Do not disclose total proved, probable and possible reserves together in the aggregate, due to the different risk profiles of the 3 categories

Engineers' Reports

- Failure to comply with all Reg. S-K §1202(a)(8) requirements
 - *E.g.*, report did not state the purpose for which it was prepared, did not disclose proportion of company's total reserves covered by the report, etc.
- Inconsistent or conflicting information, data, etc.
 - *E.g.*, pricing assumptions used for calculating SM in the forepart of the filing were not the same as those set forth in the engineers' report
- Continued requests by staff for *detailed* engineering data
- Qualifications of technical persons primarily responsible for overseeing the (i) preparation of the reserves estimates, and (ii) the reserves audit if a third party conducted a reserves audit
- Probable reserves were reported in the independent engineers' report, but not in the forepart of the filing itself
- Ancillary information referenced in the report (*e.g.*, "attached Schedule A") but was not included with the exhibit/report filed

Costs & Prices

- FASB ASC ¶932-235-50 et seq – Notes to Financial Statements
 - Property Acquisition, Exploration and Development Costs
- Treatment of various costs in calculating the SM & ceiling tests
 - *E.g.*, certain upstream operating G&A expenses not included in calculating limitation on capitalized costs, because not well-level expenditures, but were included in future costs to calculate SM
- Staff requested a summary by cost center of ceiling test calculations + a reconciliation of those costs to either the balance sheet or the SM
- Were abandonment costs included in future development costs in calculating SM?
- Infrastructure costs of development projects
- Historical & projected development unit costs differ greatly

Costs & Prices

- Property acquisition, exploration & development costs were not calculated correctly under FASB ASC §932-235-50 definitions
- Average sales prices of hydrocarbons calculated incorrectly
- Cannot recognize gain on sale of properties unless there has been “significant alteration” of relationship between capitalized costs and proved reserves
- Explain how transportation costs were incorporated into estimation of proved reserves, future net income & the SM
- MLPs - many questions about “maintenance capital expenditures” – underlying assumptions, how properties chosen, impact of derivatives, etc.
- Incorrect amortization of certain costs under successful efforts and full cost methods

Shale Plays

- Concentration in shale plays often prompted requests from staff for more information & expanded disclosures
 - Requests for technical data to support PUD bookings – *e.g.*:
 - Summaries in spread sheet format of gross estimated ultimate recoverable quantities in Bcfe & total lateral length of completion for each proved, probable and possible location in Marcellus/Utica
 - Rate/time plots for each of the 3 largest PD producing wells and for each of the 3 largest PUD locations in Marcellus/Utica
 - Reserve quantities added by drilling in Fayetteville Shale properties called into question in light of downward revisions of locations in area due to well performance – staff: additions reasonably certain?
 - Where significant % of net undeveloped acreage to soon expire
 - Miscellaneous questions: about projected declines in well costs; rebooking of PUDs that had been removed during 2012

Derivatives

- SEC: Improper accounting treatment of derivatives in financial statements and notes to financial statements
 - GAAP: commodity derivative instruments marked-to-market each period & changes in fair value = income/expense to P&L statement
 - If a true “accounting hedge,” then only “ineffective” portion of hedge is reflected in the income statement for each period
 - Many E&P companies not electing/qualifying for hedge accounting
 - Many companies reclassified their realized gains and losses in the period realized (represented by periodic/final cash settlements from those settled derivatives) into revenue or expense lines in financials
 - Some companies presented total net gains/losses and total realized gains/losses on derivative instruments in order to better reflect actual net cash realized from transactions & provide more clarity on components of derivative fair value income/loss

Derivatives

- SEC guidance on derivatives not qualifying as hedges under GAAP: separate components of derivatives' fair value should not be presented in financials
 - May not present (i) realized gains/losses on derivatives and (ii) unrealized gains/losses on derivatives, as separate line items in financial statements or in notes to financial statements
 - Likewise, may not show only total net gains/losses on derivatives and realized gains/losses on derivatives
 - Such a presentation would not comply with GAAP, and would be considered a “non-GAAP financial measure”

Derivatives

- Non-GAAP measures such as “Adjusted EBITDA” are used by E&P MLPs to measure “distributable cash flow,” which is considered relevant by investors as relating to their cash distribution amounts
- Disclosure of components of derivative fair value may be shown as non-GAAP financial measures if:
 - The measures are more specifically labeled (e.g., “net cash receipts from/payments for derivative contracts” or “net cash received/paid for settled contracts that are not hedges,” instead of “realized gain/loss on derivatives”)
 - The measures do not appear in the financial statements or notes to the financial statements and
 - There is an appropriate reconciliation to the most directly comparable financial measure under GAAP