

Reflecting the Times:

A Review of Recent SEC Staff
Comments

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Overview

- Comment letters – express views of SEC staff on E&P companies' filings & compliance with SEC disclosure rules
- Sources
 - Regulation S-X Rule 4-10(a) – Definitions of terms - Financial accounting/reporting for oil & gas producing activities under federal securities laws
 - Regulation S-K Item 1200 *et seq.* – Disclosure by Registrants Engaged in Oil & Gas Producing Activities
 - FASB ASC Topic 932 – Extractive Activities – Oil & Gas – Oil and Gas Reserve Estimation and Disclosures
 - Compliance & Disclosure Interpretations (C&DIs) issued by SEC staff in October 2009 — two additional C&DIs added in 2013

Noteworthy 2014-2016 Comments

- Development and conversion of PUDs
- Recurring changes in development plans
- Trends & uncertainties resulting from continuing low commodity prices – and quantifying the impact thereof
- Effects of E&P companies' weaker financial condition and decreased revenues on their reserves reporting
- Impacts of continuing low commodity prices on credit facilities and availability of capital
- Effects of lease expiration on PUDs reporting
- Development costs

Changes in Development Plans

- Reg. S-X Rule 4-10(a)(22) defines “proved oil & gas reserves” as those quantities of oil & gas that:
 - By analysis of geoscience & engineering data, can be estimated with ***reasonable certainty*** to be economically producible
 - From a date forward, from known reservoirs and under existing economic conditions, operating methods and regulations
 - Prior to the time at which contracts granting right to operate expire
- C&DI Question 131.04: definition of “undeveloped oil & gas reserves” requires company to **have adopted** a development plan
 - The “mere intent” to develop, without more, is not “adoption”
 - For a plan to be adopted, there must be “final investment decision”

Changes in Development Plans

- SEC: To attribute PUDs to an undrilled location, company must have adopted a development plan indicating that the location will be drilled within 5 years of the PUDs' initial booking as PUDs (unless circumstances justify longer)
- During 2014-15, staff focused on companies that had repeatedly modified their development plans from year to year without, in the staff's opinion, adequately disclosing reasons for doing so
 - Example: booked PUDs attributed to undrilled locations at end of Year One had been removed from estimated proved reserves at end of Year Two, with no explanation (or insufficient explanation) of why they were removed

Changes in Development Plans

- Year-to-year changes called into question whether there had been “reasonable certainty” that the subsequently-removed PUDs, when they had been initially booked, (i) were economically producible and (ii) would be drilled within 5 years of initial booking
 - Successive changes to a plan were interpreted by staff as a lack of commitment to the company’s previously adopted plans
- Examples of staff comments:
 - Does not appear you typically drilled PUD locations in a manner consistent with your schedule for drilling in the years following date(s) of each reserve report (*Goodrich Petroleum 12/14/15*)
 - Negative revisions of PUDs in 2014, 2012 & 2011 – how have you complied with requirements for having reasonable certainty for your plan (including final investment decision)? (*WPX Energy 9/24/15*)

Comments - Development Plan Changes

- PUD locations removed in 2014, '13 & '12 – SEC: what are your procedures intended to ensure that PUDs claimed for locations only where final investment decision made & reasonable certainty criteria met (*Atlas Resource Partners 5/22/15*)
- Drilling schedules for significant majority of PUD locations had been changed over a 4-year period, & development activity, expressed as a % of total PUDs at beginning of each year, had been very low in each following year (*Penn Virginia 4/24/15*)
- You plan to drill 62% less gross wells in 2015 than in 2014
 - Have you accounted for this reduction in adopting plan that still converts your PUDs at 12/31/14 within 5 years of initial booking?
 - What are net quantities removed as result of changes for 2015 related to your plans to drill wells scheduled for drilling during 2014, but that were not drilled in 2014? (*Devon Energy 12/3/15*)

Changes in Development Plans

- Greatly ↓ development capex planned for 2015 than in 2014, but no PUDs removed as a result of decrease (*Apache Corp*)
 - Of your PUDs at 12/31/14, what quantities were delayed, deferred or re-scheduled to future periods due to reduction? What were pricing assumptions used in preparing development schedule as of 12/31/14? (*Apache Corp 6/29/15*)
 - *Response*: table showing # of rescheduled locations & related reserves with their initial & revised years of development – 561 locations rescheduled to future periods, having 101 MMBoe of associated proved reserves – based on expected activity between \$55 and \$65 WTI price band (*Apache Corp 7/28/15*)
 - In future filings, if estimates include undeveloped volumes based on assumed future price increases, disclose volumes that won't be developed if increases don't occur (*Apache Corp 9/11/15*)

Examples of Responses

- Internal controls over approval of changes to plans
 - “Reserves Committee” approves plan that meets 5-year mandate & stays within annual capital budget constraints (*Devon Energy* 12/17/15)
 - “PUDs Review Committee” formed to evaluate yearly technical/financial merit, timing & reasonable certainty of PUD locations (*PetroQuest* 2/3/15)
 - Directors now provided more specific information about changes to previously adopted plan, including deferrals associated with locations for which PUD reserves continue to be claimed (*Gulfport Energy* 2/10/15)
- Capital was allocated to higher-return locations
 - PUD removals from some shale sites resulted from newly acquired properties having better well economics (*Atlas Resource Ptnrs* 6/30/15)
 - Of scheduled PUDs at 12/31/14, 23% no longer economic using 12-month average price for 3rd Quarter of 2015 (*Unit Corp* 8/13/15)
 - Removals due to lower prices, future drilling/completion costs & lower EURs based on offset wells’ performance (*Eclipse Resources* 5/6/15)

Impact of Low Commodity Prices

- When companies disclosed that continued low commodity prices could adversely affect them, staff requested discussion about potential impacts of lower price regime on their:
 - Proved reserves quantities and standardized measures thereof;
 - Periodic testing for impairment of carrying values of properties; and
 - Results of operations, financial condition, cash flows, liquidity and capital resources
- SEC 2003 interpretive release: "Management's Discussion & Analysis of Financial Condition & Results of Operations" (MD&A) of companies' filed reports (10-Ks, 10-Qs)
 - **“Quantitative disclosure of reasonably likely effects of material trends & uncertainties should be provided, and may be required, if reasonably available”**

Impact of Low Commodity Prices

- Quantify the impact of continuing low prices:
 - On estimated reserve volumes based on potential scenarios deemed reasonably likely to occur (*Memorial Resource 9/25/15*)
 - On proved reserves & potential future ceiling test impairments if commodity price increases do not occur (*Halcón 9/17/15*)
 - On the carrying value of your properties and their estimated reserve values based on potential scenarios considered reasonably likely to occur (*Cabot 6/23/15*)
 - Address potential full-cost ceiling impairment charge reasonably possible based on recent prices (*Matador Resources 6/25/15*)
 - Disclose reserve quantities associated with locations that won't be drilled if prices don't increase (*Laredo Petroleum 7/21/15*)

Impact of Low Commodity Prices

- Quantify the impact of continuing low prices on:
 - Drilling plans, accounting estimates related to impairment testing of properties and reported reserve volumes (*Cobalt Int'l* 6/8/15)
 - Reserve quantities, reflecting potential scenarios reasonably likely to occur, and impairment to full cost pool (*Apache Corp* 6/29/15)
 - Liquidity, capital resources & operating results (*Gulfport* 3/30/15)
 - Reserves, if their development is deferred/rescheduled to future years based on expectations of higher prices, and the higher prices are not attained (*W&T Offshore* 8/24/15)
 - Carrying value of your oil & gas properties, proved reserves and development plans – also, discuss all key factor assumptions you use in quantifying your estimates (*Diamondback Energy* 4/25/16)

Impact of Low Commodity Prices

- Examples of proposed disclosures in responses:
 - If relevant NYMEX strip prices at 12/31/14 had been used (without regard to derivatives positions) instead of prior 12-months' average prices for 2014, estimated future net revenues of our proved reserves and the estimated proved reserves volumes at 12/31/14 would have decreased by 43% and 6%, respectively (*Breitburn Energy Ptnrs* 7/30/15)
 - If we reduced the calendar 2014 12-month average price to \$50.35/Bbl for oil and \$2.69/MMBtu for natural gas, holding all other factors constant, our estimated net proved reserves would be reduced by approximately 33%, including a 10% reduction of PDs and a 60% reduction of PUDs (*Oasis Petroleum* 11/3/15)
 - See also, *Diamondback Energy* (5/9/16); *Apache Corp* (7/28/15)

Impact of Low Commodity Prices

- Chesapeake Energy disclosed in its Q2 2015 10-Q:
 - We recorded ceiling test impairment of \$5.015 bil as of 6/30/15
 - For estimating proved reserves' present values at 9/30/15, we expect price decreases of approximately \$12.31 per barrel of oil & \$0.33 per Mcf of natural gas, based on 1st-of-the-month index prices for July & August 2015 and strip prices for September 2015
 - The decreases expected to reduce present value of estimated future net revenues of proved reserves by ~\$4.1 billion in Q3 & will likely be significant factor in impairment to be recorded at 9/30/15
 - We also expect a further reduction of ~8% in our estimated proved reserves in Q3, solely related to price declines (*Chesapeake Energy* 8/18/15)

Impact of Low Commodity Prices

- Carrizo Oil & Gas proposed disclosure for its Q2 2016 10-Q:
 - For Q2 2016, we estimate after-tax impairment in carrying value of proved properties of ~\$175.0 mil to \$275.0 mil, due to forecasted 9% decline in 12-month average realized price of crude oil (from \$43.14/Bbl at 3/31/16 to estimated \$39.21/Bbl at 6/30/16)
 - Price decrease to result in negative revision to our proved reserves for Q2 2016 of 5.5 MMBoe (3% of proved reserves as of 12/31/15)
 - Removed reserves relate to locations scheduled to be developed in 2017, 2018 and 2019, so there will be no changes to our near-term development plans as a result of the revisions
 - Our key factors & assumptions used included planned drilling & completion activity, forecasted production, price differentials and development & production costs (*Carrizo Oil & Gas 5/3/16*)

Development of PUDs

- Comments also reflected prevailing low commodity prices
- Reasons for low annual conversion rates & their effects on 5-year development plan
- Inadequate explanations for variances in proved reserves and PUDs from year to year
- Effects of lower prices, slowed development plans, for PUD acreage on leases that would expire in next 3 years
- Explain differences between your historical and projected unit development costs for PUDs development
- Insufficient identification of specific causes of year-to-year net changes in (i) proved reserves and (ii) PUDs

Development of PUDs – Examples of Comments

- Reserve report: estimated PUDs at certain locations would generate positive future net revenues, but had negative present worth based on constant year-end prices/costs when discounted at 10%
 - Provide total # of these locations & associated net proved reserve quantities at 12/31/14 - clarify extent to which the locations are part of an adopted development plan (*Sanchez Production Ptnrs* 11/10/15)
- Your PUDs were revised ↓ for each of fiscal 2012, '13 & '14
 - When were volumes originally booked as PUDs & what was year they were initially scheduled to be developed? When did their initial development dates get revised & what were reasons for revisions? What were facts & circumstances causing removal of volumes? (*PDC Energy* 12/21/15)

Development of PUDs – Examples of Comments

- Major variance in recent years between planned & actual conversion of PUDs in terms of costs & volumes converted
 - For each of fiscal 2012, 2013, 2014 & for 1st 9 months of 2015, what caused actual conversion expenditures & volumes to be so different from prior years' estimates? (*Clayton Williams 9/16/15*)
 - What is role of senior management & board in reviewing/approving annual estimates? - explain extent they are made aware that proved reserve estimates for given year include PUDs scheduled for development in earlier year(s), but not developed as per previously adopted development plans (*Clayton Williams 12/15/15*)
- Explain prices you require to proceed with development of oil sands & the extent that disclosed PUDs at 12/31/14 would not be economically viable (*Harvest Operations 9/25/15*)

Expiring Undeveloped Acreage

- Disclose PUDs attributed to undeveloped acreage on leases that expire before their scheduled dates of initial development - how will you forestall lease expiration?
 - Response: only ~9.3 MMBoe of PUDs (0.8% of total proved) at 12/31/15 was attributed to expiring acreage that was not scheduled to be drilled prior to lease expiry – this acreage was only 1.8% of total undeveloped acreage at 12/31/15, all located in ND and OK primary operating areas (*Continental Resources* 5/5/16)
 - 43% of PUDs on acreage not held by production & to be developed post-primary term – what are your drilling plans under the subject leases' continuous development terms? (*Energen* 9/3/15)
 - Only 2% of our total proved reserves are assigned to locations scheduled to be drilled after expiry (*Whiting Petrol.* 10/5/15)

Unit Development Costs (UDCs)

- Major variances between actual UDCs incurred in prior year(s) and projected UDCs used in estimating standardized measure of PUDs
 - 2014 unit conversion cost for PUDs was \$25/Boe, but standardized measure at year-end included projected future UDCs at \$17/Boe - why? (*Lonestar Resources* 1/29/16)
 - 2015 incurred UDCs = \$12.30/Boe, but projected UDCs for PUD estimates = \$9.28/Boe – why? (*Continental Resources* 5/5/16)
 - Based on significant ↓'s in service costs to drill & complete, particularly in late 2015, compared to those prevailing in 2014
 - Expected development costs also reduced by DUCs (drilled but uncompleted wells), classified as PUDs (13% of total PUDs) because of relatively major expenditures required to complete wells
 - The drilling costs for DUC wells had been incurred before 2015, leaving only their completion costs remaining in 5-year projections

Comments on Financial Capabilities

- Impacts of lower prices on companies' credit facilities, borrowing bases, liquidity & capital resources
 - If reduction in borrowing base is a possibility, address the extent to which borrowing base could decrease based on expected oil & gas reserve values & other relevant factors (*Energy XXI Ltd. 4/3/15*)
 - Are you in compliance with your revised debt covenant? Quantify your current total debt to EBITDAX (*Clayton Williams 9/16/15*)
 - Given reduction in your borrowing base & negative cash flows from operations for 6 months ended 6/30/15, how did you conclude 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? (*Goodrich Petroleum 9/21/15*)
 - What were terms of waiver from lender? (*Lilis Energy 9/25/15*)

Comments on Financial Capabilities

- Impacts of lower prices on companies' credit facilities, borrowing bases, liquidity & capital resources
 - If credit ratings downgrade could require you to post additional collateral, describe additional collateral posting requirements for the company that would likely result (*Black Hills 9/15/15*)
 - You expect drilling of your PUDs inventory + expansions & extensions in next 5 years will be funded from cash on hand, cash from operations & borrowings under your credit facility
 - What are the product prices & development/production costs you are assuming for your expectations? What are minimum prices you require to continue your current programs?
 - What is current level of compliance with your debt covenants? Appears current ratio ↓ from 1.28 at 12/31/14 to 1.09 at 9/30/15 (*Lonestar Resources 1/29/16*)

Comments and Bankruptcy Proceedings

1. Miller Energy Resources (June '14 → Oct. '15)
2. Emerald Oil (July '15 → Mar. '16)
3. Hydrocarb (June '15 → Apr. '16)
4. Energy XXI (July '15 → Apr. '16)
5. Goodrich Petroleum (Jan. '16 → Apr. '16)
6. Ultra Petroleum (Feb. '16 → Apr. '16)
7. Linn Energy (Oct. '15 → May '16)
8. Berry Petroleum (Oct. '15 → May '16)
9. Penn Virginia (July '15 → May '16)
10. Breitburn Energy Ptnrs (Sept. '15 → May '16)
11. Warren Resources (Nov. '14 → June '16)
12. Atlas Resource Ptnrs (July '15 → July '16)
13. Maxus Energy (sub of YPF SA) (Jan. '15 → June '16)
14. Halcón Resources (Oct. '15 → July '16)

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