

SEC Comments 2017-2018

Ryder Scott Houston Reserves Conference

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2017-18 observations

- Comments were, for the most part, similar to those issued in 2016-17:
 - The SEC staff's comments continue to be more detailed, focusing on more subtle disclosure items embodied within SEC & FASB accounting rules and interpretive guidance;
 - Companies' responses reflect an increasing familiarity with, and understanding of, these rules and interpretive guidance
- Less back-and-forth correspondence between the staff and companies
- More “we’re not reviewing” letters on securities offerings
- More comments on business acquisition transactions and companies emerging from bankruptcy
- Topic appearing to receive greatest number of comments = **Changes in net quantities of total proved reserves**
 - Disclosure required under FASB ASC 932-235-50-5 - generally appears in an unaudited note to the annual financial statements, entitled something like “Supplemental Information on Oil and Natural Gas Operations” (“SMOG”)
- Potential changes in the wind?

The five-year rule; development plans



“And, while there’s no reason yet to panic, I think it only prudent that we make preparations to panic.”

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“I Liked You Better Before I Knew You So Well” — The 5-year rule

1. Conversion rate of small independent’s PUDs for the past 4 years (2%, 4%, 2% & 12%) appeared to be insufficient in order for it to be able to develop its reserves over the next 5 years (*Sept. 2017*)
2. Independent producer was asked to (i) disclose reasons for its limited progress in prior fiscal year, and (ii) explain whether its plans relating to the conversion of its remaining PUDs had changed in order to ensure that its estimates met the “adopted development plan” criteria (*i.e.*, that all of its PUDs were scheduled to be drilled within 5 years of their initial disclosure) (*Dec. 2017*)
3. Diversified energy company said that it removed from its books PUDs that remained undeveloped after 5 years from their initial disclosure – staff asked company to explain the steps it routinely took to (i) review its development plan annually & (ii) evaluate interim & annual changes in its development schedule when determining whether its PUDs continued to meet the requirements for disclosure as PUDs (*Aug. 2017*)

“I Liked You Better Before I Knew You So Well” — The 5-year rule (cont’d.)

4. Large independent indicated that ~81 MMBoe of its PUDs were associated with drilled-but-uncompleted (DUC) wells at 12/31/16 – staff asked company to provide the net quantities of PUDs attributed to those wells at 12/31/16 that were not scheduled to be completed *and their related reserves converted to developed status* within 5 years of their initial disclosure (Aug. 2017)
5. Natural gas subsidiary reported reserves as PUDs when a drill or spud date, rather than a completion date, was scheduled to occur within 5 years after the date of initial disclosure - to classify as PUDs, Reg. S-X* requires adoption of a development plan indicating locations that are scheduled to be drilled within 5 years of initial disclosure, *which should entail completion* of well (Nov. 2017)
 - Reg S-K* (i) states that (i) “wells drilled” refers to the number of wells completed, and (ii) requires disclosure when PUDs “remain undeveloped for 5 years or more after disclosure as [PUDs]” – this should encompass any locations for which the wells have not been completed within 5 years of their initial disclosure as PUDs

* Reg S-X = Regulation S-X (financial statements in SEC filings); Reg S-K = Regulation S-K (textual disclosures in SEC filings)

“I Liked You Better Before I Knew You So Well” — The 5-year rule (cont’d.)

6. To support its claimed PUDs, small producer was asked to provide a roll-forward for each of its PUD locations by year of their initial disclosure, starting with 12/31/11 and continuing for each year thru 12/31/16 (*Dec. 2017*)
 - For each PUD location disclosed at each year-end, provide the net reserves & expected completion date;
 - Identify any previously disclosed locations removed & the reasons for their removal (*e.g.*, converted to PD, changes in previously adopted development plan, exceeded 5-year time period, uneconomic based on year-end prices); and
 - Provide development schedule as of 12/31/16 indicating, for each future annual period, the individual wells to be drilled, the net quantities of proved reserves attributed to those locations & the estimated capex relating to each well required in order to convert the associated PUDs to developed status
7. Large E&P company’s conversion rates of 13% & 10% for its PUDs in past 2 years appeared to be insufficient - company response noted that, excluding certain multi-phase offshore operations, conversion rates were 16% and 22% - plus, PUDs classified as PUDs for more than 5 years from initial disclosure represented only 1% of its total proved reserves (*May 2018*)

“She Got the Gold Mine and I Got the Shaft” —Development plans

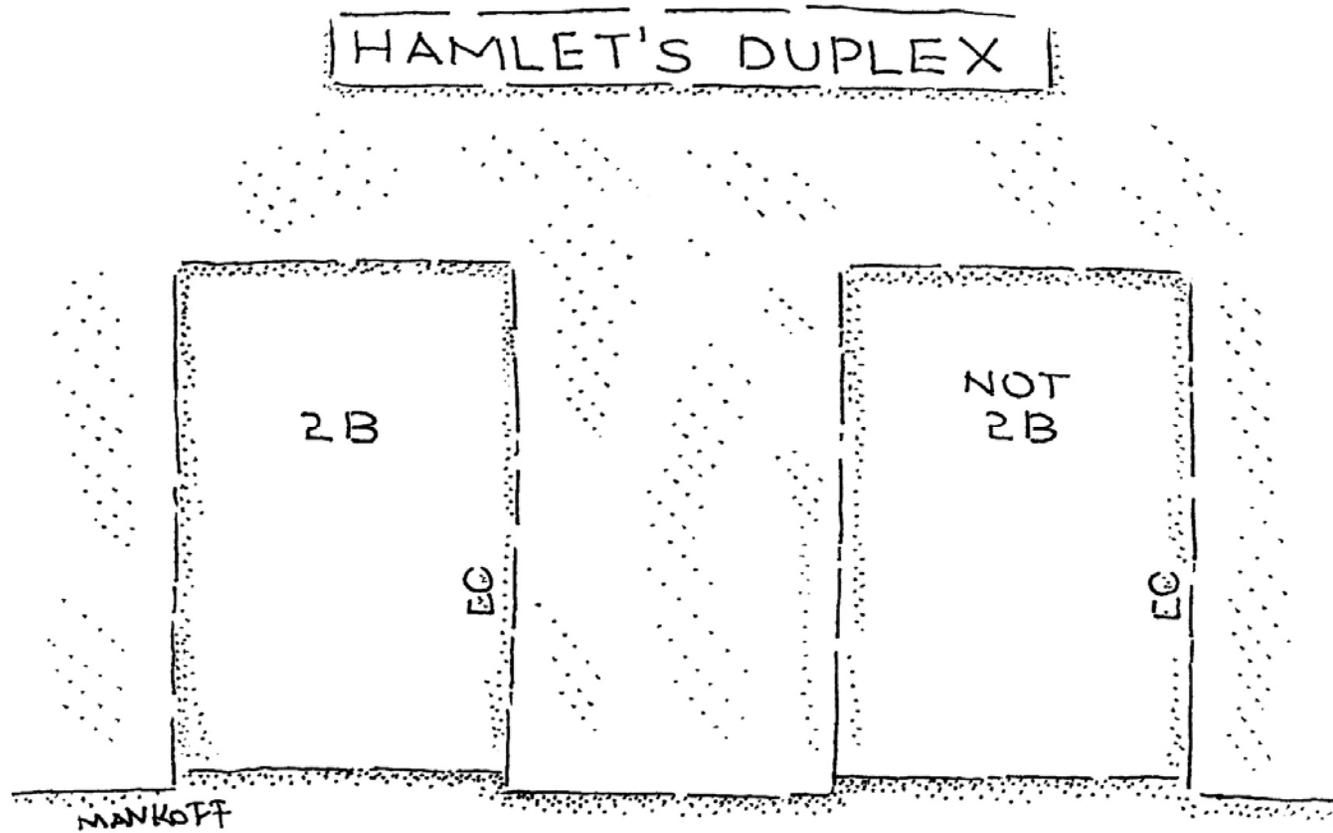
1. U.S. independent removed 98MMBoe of PUDs in prior year due to reductions in estimated capex in its 5-year development plan – staff asked: For each operating area, when were PUD locations & associated volumes of PUDs initially recorded? – To what extent did any of the scheduled development dates for these locations change between the time initially recorded & the time removed? (*Sept. 2017*)
2. Independent producer’s development plan as of year-end for one field included a relatively large amount of capex over 4 years – Reg. S-X “reserves” definition requires at least a reasonable expectation there will exist all financing required to implement the project – given producer’s financial condition & liquidity, what were its plans to obtain the required financing? (*Mar. 2017*)
3. For 2 of its major operating areas, independent E&P company had low PUD conversion rates in the prior year, plus very few wells scheduled for that year had been drilled in that year – staff asked company to:
 - Explain how it concluded that it had adopted a development plan and made a final investment decision with regard to those PUDs, and
 - Provide details specifying the steps taken to demonstrate more than a “mere intent” to develop the PUDs (*Sept. 2017*)

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“She Got the Gold Mine and I Got the Shaft” —Development plans (cont’d.)

4. For each year since 2012, independent producer had reclassified previously disclosed PUDs to unproved reserves for locations no longer expected to be developed within 5 years of initial disclosure – producer was asked to explain (i) reasons for sequential revisions, and (ii) extent to which these PUD locations at each year-end were part of an adopted development plan reviewed by management & approved by your board of directors (*Dec. 2017*)
5. Independent E&P company’s acreage assigned to leases expiring in 2017, 2018 & 2019 represented 31%, 21% & 13%, respectively, of its total net undeveloped acreage at year-end – staff asked:
 - To what extent has the company assigned PUDs to locations currently scheduled to be drilled after lease expiration?
 - If material quantities of net PUDs were assigned to these locations, what are the number of locations and the related reserve quantities?
 - What are company’s plans, and the expenditures required, to extend the expiration dates of these leases? (*Sept. 2017*)

Changes in total proved reserves & PUDs; standardized measure calculations



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***“I Still Miss You Baby, but My Aim's Gettin' Better”* —Changes in total proved reserves & PUDs**

1. Offshore producer's table disclosing changes in net quantities of total proved reserves during year prompted staff requests:
 - To explain significant changes for each line item entry (*i.e.*, revisions of prior estimates, improved recovery, extensions & discoveries, purchases & sales of minerals in place, production);
 - To separately identify & quantify each factor (including offsetting factors) contributing to a significant change in order to fully explain the net change between periods;
 - To indicate, to the extent that 2 or more factors contribute to a significant change, the net amount attributable to each factor along with a narrative explanation;
 - To identify the factors that resulted in the revisions to previous estimates of reserves (*i.e.*, commodity price changes, well performance, unsuccessful or uneconomic PUD locations, removal of PUD locations due to changes in development plan)

(Jan. 2018)

“I Still Miss You Baby, but My Aim's Gettin' Better” —Changes in total proved reserves & PUDs (cont'd.)

2. Small producer had combined separate & unrelated factors (e.g., adjustments in future drill schedule & well performance) to arrive at the “revisions” line item figure in its changes to PUDs table – staff comment: Each individual factor that contributed to a material change should be separately identified and quantified in order to fully explain the change (*Sept. 2017*)
3. E&P company’s changes in its total proved reserves table showed negative revisions (*June 2018*):

- For 2017 - ~4,000 MBOE “due primarily to changes in type curves”
- For 2016 - ~2,000 MBOE “due primarily to technical revisions”

Staff requested description of circumstances surrounding these revisions:

- Describe the specific properties and development status of underlying volumes
- Indicate when volumes involved were initially recorded, & describe any upward or downward revisions between time of initial recording and the described revisions
- Explain basis for concluding that the factors that resulted in the revisions did not impact any other volumes reported as of 12/31/17 or 12/31/16, and that the remaining reported volumes met the Reg S-X “proved reserves” definition

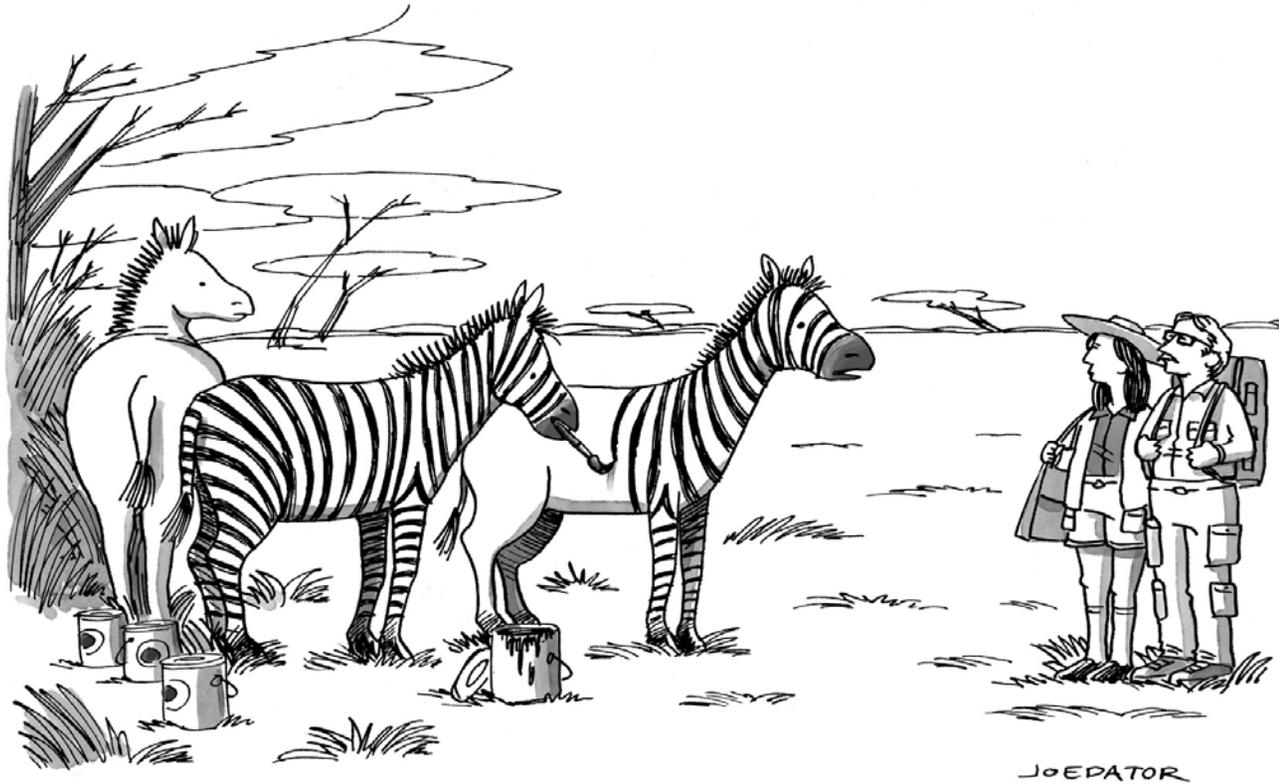
“I Still Miss You Baby, but My Aim's Gettin' Better” —Changes in total proved reserves & PUDs (cont'd.)

4. Producer's net quantities of crude oil & NGL proved reserves were combined into one aggregated figure in changes table – NGL reserves are required to be disclosed separately if NGL quantities are “significant” (*Nov. 2017*)
5. Independent disclosed that increase in total proved reserves in the prior year resulted primarily from extension and infill drilling in certain fields, which it classified as “extensions and discoveries” in its changes in proved reserves table – the staff asked whether the proved reserves added by infill drilling should instead be classified as revisions to previous estimates (*Nov. 2017*)
 - Did the additions result from an extension of the proved acreage of old reservoirs through additional drilling, or the discovery of new fields with proved reserves or new reservoirs of proved reserves in old fields?
6. In its changes in total proved reserves table, NOC included flared gas consumed in operations in its natural gas production volumes – staff asked if its proved reserves also included fuel gas volumes, & requested that it provide the net quantities of fuel gas reserves, if material (*Sept. 2017*)

“If the Phone Don't Ring, You'll Know It's Me” — Standardized measure calculations

1. SEC's Feb. 2004 “letter to CFOs” - Calculation of net cash flows must include cash outflows associated with settlement of asset retirement obligations
 - Staff asked small independent whether the asset retirement obligations used in calculation of its standardized measure included costs related to future undrilled proved locations for which it had assigned PUDs as of the end of the prior year - if these costs were not included, staff asked why revising the calculation was not necessary (*Dec. 2017*)
2. Company incurred ~\$10.1 Mil in capex to convert 5.3 MMboe of PUDs to developed status, equating to a unit development cost (UDC) of ~\$1.906 per boe – this was much less than the UDC indicated from its standardized measure (equating to a projected future UDC of ~\$9.78 per boe) – staff asked company to explain significant differences between historical & projected future development costs (*Sept. 2017*)
3. A changes in standardized measure table contained a “Timing differences & other technical revisions” line item – staff asked: How did you determine that these components should not be included as part of the other sources of change (*i.e.*, revisions) as required by FASB rules? (*April 2018*)

Prices, revenues & costs; production



"You weren't supposed to see this."

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“I Sold a Car to a Guy Who Stole My Girl, but It Don't Run, So We're Even” — Prices, revenues & costs

1. Small independent incurs contractual non-cancelable annual fixed costs to reserve pipeline capacity for gathering & processing operations for certain of its shale assets – company told staff that these costs were “captured entirely within [its] PDP cash flows as of [year-end]” (*Aug. 2017*)
 - Staff said that if the costs were incurred in order to deliver production to market & therefore necessary for future production & development, company should explain (i) its rationale for excluding all of these costs from its cash flows estimated for its PDNP, shut-in & undeveloped reserves over the term of the contract, and (ii) how it confirmed the economic producibility of its PDNP, shut-in & undeveloped reserves in order to classify them as proved
2. Regarding prices used in computing reserves as of year-end, small producer disclosed a negative gas price, after giving effect to “price differential adjustments” – staff asked for an explanation of the circumstances and factors that resulted in a negative average realized gas price (*Sept. 2017*)
 - Rules require disclosure of important economic factors that affect particular components of proved reserves – these include contractual obligations to produce significant portion of reserves at prices substantially below those at which the production could otherwise be sold, absent the contractual obligations

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“You're the Reason Our Baby's So Ugly” — Production

1. Disclosure of production by final product sold is required for each field or geological formation holding >15% of total proved reserves – producer argued that the Permian Basin constitutes a single “field” – staff noted that part of the definition of “field” in Reg. S-X provides that a field is “intended to identify localized geological features as opposed to the broader terms of basins, trends, provinces, plays, areas-of-interest, etc.” (*Feb. 2018*)
2. Staff asked E&P producer if NGLs were extracted from its produced gas & sold separately, or if its natural gas was sold without extracting NGLs
 - If extracted & sold separately, staff asked the company to provide the net quantities of NGLs produced during last 3 years, & the net quantities of proved reserves associated with NGLs at the end of each period
 - If NGL quantities are not extracted & sold separately, the company should indicate that the NGLs are included as part of natural gas production & proved reserves (*Dec. 2016*)

Investments; progress in developing PUDs; present activities; miscellaneous



"Don't mind me, Richie—it's just the rabies talking."

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“She Got the Ring and I Got the Finger” — Investments & progress made to develop PUDs; present activities

1. Staff noted that producer did not include a discussion of the investments and progress its had made during the year to convert its PUDs to PDs, including capital expenditures (*July 2018*)
2. Staff asked company, in its discussion of drilling results & present activities, to expand its disclosure to clarify that all wells “drilled” were drilled and completed wells (*Feb. 2018*)
 - Staff referred to definitions of “drilled well” and “completion” under Reg S-K (*i.e.*, “number of wells drilled” means “wells completed”)
3. NOC said that its present activities in one of its major overseas operating areas involved “project evaluation” of a major venture there, which included the economic use of certain project equipment in the future, and the “preservation of the ... facilities for asset sustainment”
 - The staff asked NOC to provide additional information clarifying its present activities, including more complete description of the project equipment and how that impacted the production of its PD reserves (*Aug. 2017*)

“*Mama Get a Hammer (There's a Fly on Daddy's Head)*” — Miscellaneous

- Impairments: Large company reported impairments for certain properties during year due to reservoir performance - was asked by staff to describe the specific properties & the reserve volumes involved, and the aspects of reservoir performance that led to the impairment, including an explanation of:
 - How & when the reservoir performance at issue had been initially identified, including whether it had been observed in any earlier periods, and
 - How the reservoir performance was taken into consideration in connection with determining quantities of PUDs at year-end for related properties (*Sept. 2017*)
- Trends & uncertainties: Staff informed large producer that it appeared that more information could be disclosed by it to help a reader understand the reasonably likely effect of material trends & uncertainties, including with regard to commodity prices
 - Remarks made by the company's management during an earnings call earlier in the year included statements that it anticipated oil prices to rise moderately through the year & that planned capital spending anticipated oil prices remaining approximately as reflected in the futures markets (*June 2017*)

“Mama Get a Hammer (There's a Fly on Daddy's Head)” — Miscellaneous (cont'd.)

- Derivatives: Independent E&P company reported derivative contracts in effect for current and following year at weighted average prices of \$XX.00 & \$XX.00 per barrel, respectively - staff pointed out that in a table elsewhere in the filing, it appeared that those contracts were subject to reset provisions in the event actual prices fell below certain specific levels – staff asked company to revise its disclosures as may be necessary to provide a more complete description of the terms of the derivative contracts (Sept. 2017)
- Other: Staff asked a small company about an inconsistency in its filing regarding the disclosure of significant PUD reserves and the lack of disclosure of any undrilled undeveloped acreage (it had categorized all of its acreage as “developed”) – it informed company that undrilled acreage held by production should be disclosed as *undeveloped* acreage under Reg S-K, and requested it to revise its disclosure (Sept. 2017)

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APPENDIX – Origins of the five-year rule, etc., etc.



*“Let’s never forget that the public’s desire for transparency
has to be balanced by our need for concealment.”*

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Interpretive guidance: Current Disclosure Issues (6/30/2000); Accounting & Financial Reporting Guidance (3/31/2001)

- The SEC had cited and relied upon the above-referenced interpretive guidance in certain of its enforcement proceedings before the 2008 amendments to the oil and gas reporting rules, noting that the guidance had “emphasized conservatism underlying the definition of proved reserves”
 - “[R]easonable certainty implies that, as more technical data becomes available, a[n] ... upward revision is much more likely than a ... downward revision”
 - Observed that “[e]conomic uncertainties such as the lack of a market (e.g. stranded hydrocarbons) ... can also prevent reserves from being classified as proved”
 - “[I]n developing frontier areas ... [i]ssuers must demonstrate that there is reasonable certainty that a market exists for the hydrocarbons & that an economic method of extracting, treating & transporting hydrocarbons to market exists (or is feasible) & is likely to exist in the near future”

Interpretive Guidance: Current Disclosure Issues (6/30/2000); Accounting & Financial Reporting Guidance (3/31/2001) (cont'd.)

- A commitment to “develop the necessary production, treatment & transportation infrastructure is essential to attribution of [PUDs]. *Significant lack of progress on the development of such reserves may be evidence of a lack of commitment*” [Emphasis added]
 - Guidance provided examples of “affirming a commitment,” such as signed sales contracts for the production; RFPs to build facilities; signed acceptances of bid proposals; MOUs between organizations & governments; firm plans & timetables established; approved AFEs to build facilities; approved environmental permits
 - “Reasonable certainty of procurement of project financing ... is a requirement for the attribution of proved reserves. *An inordinately long delay in the schedule of development may introduce doubt sufficient to preclude the attribution of proved reserves.*” [Emphasis added]
- Automatic renewal of permits & licenses “cannot be expected ... unless there is a long & clear track record which supports the conclusion that such approvals & renewals are a matter of course”

SEC Concept Release on Possible Revisions to Disclosure Requirements Relating to Oil & Gas Reserves (Dec. 12, 2007)

- In the Concept Release, SEC observed that its then-current rules did not:
 - Define “reasonable certainty” for proved reserves – SEC interpreted term to mean “a level of certainty such that, as more information about a reservoir becomes available, it is more likely than not that the additional data will confirm or enhance the company’s original estimate of the quantity it can ultimately recover” (p. 6); or
 - Specify a period of time during which a company should expect to commence drilling a new well (p. 8)
- Concept Release noted that some industry commentators had expressed concern that companies continued to categorize quantities of PUDs for extended periods of time without taking any action to develop the reserves
 - “This raises the question as to whether such quantities originally met, or currently meet, the reasonable certainty requirement” (p. 8)
- Concept Release noted the release of the Petroleum Resources Management System (PRMS) in February 2007

Proposed & Final Rules' Releases – Modernization of Oil & Gas Reporting (6/26/2008; 12/31/2008)

- Proposed rules prohibited assigning proved status to undrilled locations "if a development plan has not been adopted *indicating that the locations are scheduled to be drilled within 5 years*" (p.40)
 - The SEC there observed again the concerns of "some commenters responding to the Concept Release regarding companies that carry alleged PUDs for lengthy time periods" (p. 75)
- In the proposed rule release, SEC said that "several commenters" had recommended that PUDs remaining classified as PUDs for 5 years or longer should be removed from the proved category
 - And noted that the "PRMS guidelines indicate that 5 years is a benchmark for a reasonable timeframe to initiate the development of reserves, although they recognize that this timeframe depends on the specific circumstances" (p. 76)
- Final release stated that new rules' intent was not to exclude reserves from projects typically taking more than 5 years to develop - the SEC agreed that the rule should allow reserve recognition for projects expected to run more than 5 years, provided that specific circumstances existed (in the final rules, the SEC substituted the term "specific" for the word "unusual")

Comment letters to SEC from industry

- Comment letters from industry *cited* in the proposed & final rules' releases as being in favor of the 5-year rule did not appear that numerous, or particularly strongly in favor of it –
 - In fact, there appeared to be more industry letters cited that opposed the 5-year rule than those in favor of it
- SPE comment letter to SEC (2/18/2008)
 - Cited 2007 PRMS § 2.1.2 - “A reasonable time frame for the initiation of development depends on the specific circumstances & varies according to the scope of the project. While 5 years is recommended as a benchmark, a longer time frame could be applied if, for example, development of economic projects are deferred at the option of the producer for, among other things, market-related reasons, or to meet contractual or strategic objectives. In all cases, the justification for classification as Reserves should be clearly documented.” [*Cf., the 2018 PRMS*]

Comparison of 2007 PRMS to 2018 PRMS*

- §2.1.2.3 - under “*Determination of Commerciality*”

“To be included in the Reserves class, a project must be sufficiently defined to establish both its technical and commercial viability as noted in §2.1.2.1. There must be a reasonable expectation that all required internal and external approvals will be forthcoming and ~~there is~~ evidence of firm intention to proceed with development within a reasonable time-frame. A reasonable time-frame for the initiation of development depends on specific circumstances and varies according to the scope of the project. While five years is recommended as a benchmark, a longer time-frame could be applied where justifiable; where for example, development of economic projects that take longer than five years to be developed or are deferred ~~at the option of the producer for, among other things, market-related reasons, or~~ to meet contractual or strategic objectives. In all cases, the justification for classification as Reserves should be clearly documented.”

* 2018 PRMS changes to 2007 PRMS **are in red**

2018 PRMS - relevant changes (cont'd.) *

- §2.1.3.6.4 - under “*Reserves Status*”

“Where Reserves remain Undeveloped beyond a reasonable time-frame or have remained Undeveloped ~~due to repeated~~ owing to postponements, evaluations should be critically reviewed to document reasons for the delay in initiating development and to justify retaining these quantities within the Reserves class. While there are specific circumstances where a longer delay (see §2.1.2 *Determination of Commerciality*) is justified, a reasonable time-frame to commence the project is generally considered to be less than five years from the initial classification date.”

* 2018 PRMS changes to 2007 PRMS **are in red**

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