January 14, 2016

Top SEC Disclosure Triggers for E&P Companies' 2015 Annual Reports: Forewarned is Forearmed

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Exploration and production ("**E&P**") companies are confronting the harshest industry environment in decades. E&P companies experienced a drastic deterioration in prices for their oil and natural gas production during the second half of 2014, which remained at depressed levels throughout 2015. The velocity and steepness of the decline has resulted in deteriorating operating cash flows, results of operations and financial condition for many E&P companies.

In light of this turmoil, the Securities and Exchange Commission ("**SEC**") has stepped up its oversight of publicly-held E&P companies. The staff of the Division of Corporation Finance of the SEC, the group responsible for reviewing reporting companies' filings, has within the last 12 months issued a number of comment letters to E&P companies relating to disclosures about the effects of these weakened market conditions. The comment letters, which are publicly available on the SEC's EDGAR system, suggest that reporting E&P companies should be taking into account these recent staff views when preparing their 2015 year-end annual reports. In particular, the staff has asked companies to:

1. Expand disclosure in the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) and other relevant sections of their filings regarding the impacts of lower commodity prices on proved reserve estimates and potential future impairments, including quantifying possible future effects;
2. Address whether or not the depressed price environment has affected or is expected to affect the company's access to capital and drilling plans;
3. Describe the internal controls used to ensure "reasonable certainty" in estimating PUD reserves when development plans are frequently modified; and
4. Explain low PUD conversion rates and detail changes in year-to-year reserves reconciliations.

Impacts of Lower Commodity Prices on Reserve Estimates and Impairment Testing. Numerous companies received comment letters during 2015 requesting additional disclosures about the potential effects of lower commodity prices on:

- Their reported proved reserves quantities, along with the estimated standardized measure of discounted future net cash flows relating to those reserves (the "standardized measure"); and
- Any potential impairment of the carrying values of their oil and gas properties for purposes of ceiling limitation tests and other impairment testing under full cost and successful efforts accounting methods.

In many comment letters, the staff relied on a 2003 SEC Interpretive Release relating to the MD&A section of companies' periodic reports. In particular, the release encourages companies to (i) add an introductory overview section that includes the most important matters on which a company's executives focus in evaluating financial condition and operating performance, (ii) discuss and analyze the effect of material trends, demands, commitments, events and uncertainties and (iii) address material implications of uncertainties associated with the methods, assumptions and estimates underlying a company's critical accounting measurements. Most notable in this area were comments that requested companies to *quantify* the potential future impact of the low commodity prices on their proved reserves and the carrying values of their properties.

> ***Example of SEC staff comment:*** *Unless you have determined that it is not reasonably possible that a continuation of the current economic environment would lead to material adverse effects, you should provide quantified information regarding the reasonably possible effects of a continuation of current commodity prices to the extent that quantified information is reasonably available. Refer to the guidance in … Sections III.A, III.B.3, and V of SEC Release Nos. 33-8350; 34-48960 … , as it relates to disclosures in an introductory section or overview, the effects of material trends and uncertainties, and critical accounting estimates.*

In response to these comments, many companies resisted providing any such quantification. Numerous companies contended that estimating the impact of lower prices on their future proved reserves and impairment testing would be imprecise and subjective, based upon abstract estimates of future prices, production, performance, costs and other conditions. After pushback from the staff, however, many companies ultimately provided quantification information, agreeing to include such information in future reports where applicable and in some cases agreeing to amend previously filed reports.

- One company agreed to provide in the MD&A of its upcoming quarterly report a sensitivity analysis showing that if the relevant NYMEX commodity strip price as of December 31, 2014 had been used instead of the SEC-required average price for 2014, the estimated future net revenues of the company's proved reserves and estimated proved reserves volumes as of December 31, 2014 would have decreased by approximately 43 percent and 6 percent, respectively (*Breitburn Energy Partners LP*).
- Another company agreed to file an amended Form 10-K (Form 10-K/A) that contained the following additional MD&A disclosure (*Penn Virginia Corp*.):

  > ***Added Disclosure in 2014 Form 10-K/A*****:** *A prolonged period of depressed commodity prices could have a significant impact on the value and volumetric quantities of our proved reserve portfolio, assuming no other changes in our development plans. At year-end NYMEX calendar year forward contract strip prices, the present value (discounted at 10 percent per annum) of estimated future net revenues of our proved reserves would be approximately 63 percent smaller and total proved reserve equivalent volumes would be approximately 24 percent smaller compared to the results obtained using SEC mandated 2014 beginning of the month average prices held constant, as is required for the estimation of proved reserves and the calculation of the related standardized measure of discounted future net cash flows.*

- With respect to future quarterly and annual reports in periods when it expected to incur future impairments and downward revisions in proved reserves caused by changes in commodity prices, a company agreed to include additional disclosures showing the effects of the changes in prices by using an illustrative average price calculated over a 12-month period, based upon actual commodity prices available for the nine months preceding the most recent reporting date and prices reasonably available (and held constant) after the end of that reporting period (*EXCO Resources, Inc*.).
- A company included in the MD&A in its 2015 second quarter report disclosure stating that, by adjusting the 12-month average price used at 2014 year-end to an estimated average price for the third quarter of 2015, the company expected to recognize a 2015 third-quarter impairment of approximately $300 million, partially resulting from a decrease in its PUDs of approximately 23 percent (*Unit Corp*.).
- A company included in the MD&A in its 2015 second quarter report disclosure of a $5.015 billion impairment to the carrying value of its properties for that quarter, along with an estimate that it would incur a further reduction in the present value of estimated future net revenues of its proved reserves of

$4.1 billion for the third quarter of 2015, and a further reduction in its estimated proved reserve quantities of approximately 8 percent (*Chesapeake Energy Corp*.).

Other companies receiving staff comment letters in 2015 requesting additional information (including quantitative disclosures) on the expected impact of lower commodity prices include *Black Stone Minerals, L.P.*; *Energy XXI Ltd*; *Gulfport Energy Corp.*; *Vanguard Natural Resources, LLC*; *EQT Corp.*; *Cobalt International Energy Inc.*; *Cabot Oil & Gas Corp.*; *Matador Resources Company*; *Gran Tierra Energy Inc*.; *Cimarex Energy Co*. and *Eclipse Resources Corp*.

Access to Capital; Effects of Changes in Capital Expenditure Budgets. As a result of the depressed price environment, the staff has focused on companies' abilities to weather the downturn by having access to sufficient capital, internally-generated or otherwise, to fund their operations and carry out their business plans. Relying on the release described above, the staff has requested enhanced disclosures where companies disclosed potential impacts of the lower prices regime on their credit facilities. The staff has also asked companies to disclose how changes or potential changes to their capital expenditure budgets due to the pricing environment would impact their drilling plans and PUD estimates.

- One company, in connection with a staff review of its registration statement on Form S-1, was asked to provide quantitative disclosure about the expected impact of lower prices on its borrowing base that was scheduled to be re-determined in the near future, and the steps the company intended to take to address uncertainties existing with respect to its liquidity. The company added a statement to its filing that while it expected its borrowing base to be reduced, it did not believe the decrease would adversely affect its liquidity (*Black Stone Minerals, L.P*.).
- Where another company had disclosed that there could be a reduction in the borrowing base under its revolving credit facility if lower commodity prices continued, the staff requested additional disclosure addressing the extent to which the borrowing base may decrease based on expected oil and gas reserve values and other relevant factors. The company agreed to include additional disclosure regarding the anticipated reduction of its borrowing base in its upcoming quarterly report. The staff noted that the company had reduced its capital expenditure budget and asked the company to describe how this change was expected to affect plans to develop PUDs in a manner consistent with the schedule underlying the determination of those reserves. The company agreed to include a risk factor regarding drilling schedule implementation risk in its upcoming annual report (*Energy XXI Ltd*.).
- Where a company had disclosed that its budgeted capital expenditures for 2015 were being cut from $640 million to $352 million, the staff requested information about the types of capital expenditures that would be reduced by this change in the company's budget (*e.g.*, proved developed reserves awaiting completion, PUDs, unproved properties, etc.) and a description of any resulting impact to the company's financial statements. In response, the company agreed to include additional disclosure in its future SEC filings describing how the reduced budget would impact reserves and drilling activity, including the statement that "In addition, this reduction in planned capital expenditures will likely result in a slower rate of growth of our proved reserves through extensions and discoveries than previously forecasted as development of our acreage position is deferred to subsequent years." (*Eclipse Resources Corp*.).
- Where a company disclosed that under its 2015 business plan, it was projected to be operating near the limits of the leverage permitted by its credit revolver, the staff asked whether the estimated prices underlying the company's 2015 business plan assumed increases over current prices. The company responded by stating that although its 2015 business plan projected that it would operate near the limits of the leverage permitted by its revolving credit facility, the company believed that it had available various alternatives to ensure that it did not exceed those limits, including deferral of capital projects and waivers or amendments of its leverage covenants.

When asked to describe the impact of commodity prices on its drilling plans, the company agreed to amend the MD&A in a Form 10-K/A to include the following: "In the event that commodity prices continue to decline, or if prices remain depressed for an extended period beyond 2015, we may be required to further reduce the magnitude of our drilling program." The company added further disclosure in its Form 10-K/A as follows:

Added Disclosure in 2014 Form 10-K/A: *During 2014, we incurred capital expenditures of approximately $381 million in connection with the conversion of proved undeveloped reserves to proved developed reserves. Several factors impacted the rate at which proved undeveloped reserves were converted to developed status. Our Eagle Ford Shale development plan was significantly affected by the dramatic drop in oil prices in the second half of 2014. As we continued to develop and become more knowledgeable about our Eagle Ford Shale acreage up to and through 2014, we also changed our development plan so that we could concentrate our limited capital on our highest economic return locations. This resulted in in the deferral of our planned development of certain proved undeveloped reserves. Our conversion rate was also affected by the decision of the operator of several non-operated locations in the Granite Wash in the Mid-Continent to defer drilling of those locations initially scheduled for 2014 (Penn Virginia Corp.).*

- Where a company reduced its 2015 capital expenditure spending plan in response to decreases in commodity prices, the staff asked the company how this would impact the company's ability to develop new PUDs in a timely manner and whether this change was made in anticipation of an improvement in commodity prices over the term of the company's development plan. The company stated that it did not believe its decision to reduce its capital expenditure budget would impact its ability to develop its PUDs in a timely manner and agreed to add the following disclosure in the "Outlook" section of the MD&A in future reports: "A prolonged low price environment could adversely affect the pace of the development of the Company's reserves." (*EQT Corp.*)

Recurring Modifications to Development Plans; Internal Controls. For companies that had changed the development plans for their PUDs from period to period (*i.e*., PUDs attributable to different drilling locations were moved into and out of the companies' estimated proved reserves from year to year without explanation) the staff called into question whether the PUDs on the companies' books had truly been estimated as having "reasonable certainty" that they would be drilled within five years and would be economically producible. The definition of "proved oil and gas reserves" contained in the SEC's Regulation S-X requires that the reserves be estimated with "reasonable certainty" to be economically producible from that date forward, from known reservoirs and under then-existing economic conditions, operating methods and government regulations, and prior to lease or concession expiration.

In order for undrilled locations to be classified as having undeveloped reserves that can be booked as PUDs, the SEC requires that there be a development plan adopted by the company that indicates that the locations will be drilled within five years, unless specific circumstances justify a longer time. Staff guidance provides that the mere intent to develop the PUDs by itself does not constitute "adoption" of a development plan, and by itself would not justify recognition of reserves. According to the staff, adoption of a development plan requires a "final investment decision" made by the producer.

In 2014-2015, the staff issued a number of comment letters to companies that had made considerable changes to their five-year plans, viewing those changes as evidencing a lack of commitment by the companies to their previously approved plans, and thereby calling into question the reasonable certainty of the reserves. In many of these letters, the staff questioned whether the companies' internal controls over their reserves estimation process were effective.

- The staff asked one company about the processes through which changes to its previously adopted PUD development plans and its historical PUD conversion rates were taken into consideration in determining that its current year PUD volumes met the reasonable certainty criteria. The company agreed to add to its upcoming 2014 Form 10-K a description of changes it had made to its internal controls used in its reserve estimation process, including controls related to the processes through which changes to its previously adopted PUD development plans and historical PUD conversion rates were considered (*Petroquest Energy, Inc*.).

  Additional Disclosures Provided in 2014 Form 10-K: *[W]e maintain a five year development plan that is updated and approved annually by our PUD Review Committee [a committee comprised of the company's senior executive officers and reservoir engineering manager] with input from our executive team and asset managers and reviewed quarterly by our executive team and asset managers. Our development plan includes only PUDs that we are reasonably certain will be drilled within five years of booking based upon qualitative and quantitative factors including estimated risk-based returns, current pricing forecasts, recent drilling results, availability of services, equipment and personnel, seasonal weather patterns and changes in drilling and completion techniques and technology. … During 2014, we enhanced our reserve booking policies and procedures by establishing a committee that annually reviews our PUD reserves. Our PUD Review Committee (the "Committee") meets annually in connection with each year-end reserve report. The Committee is responsible for reviewing all PUD locations, not only in terms of technical and financial merits as reviewed by our independent petroleum engineering firm, but also to apply a more robust evaluation of the timing and reasonable certainty of the development plan in light of all known circumstances including our budget, the outlook for commodity prices and the location of ongoing drilling programs. The Committee's evaluation of reasonable certainty of the development plan includes a thorough assessment of near term drilling plans to develop PUDs, a review of deviations to previously adopted development plans and a review of historical PUD conversion rates.*

- Where a company had disclosed in its 2014 Form 10-K downward revisions to its PUDs for its 2014, 2013 and 2012 fiscal years, the staff viewed these revisions as reversals of the company's prior investment decisions for approximately 39 percent, 24 percent and 27 percent of its total PUDs disclosed at the beginning of 2014, 2013 and 2012, respectively. The company explained that the revisions had been primarily due to reductions in its drilling plans in certain shale areas and necessary changes to its pricing scenarios, which resulted in the removals. The staff requested a detailed explanation of the company's processes and procedures involved in preparing its annual reserves estimates, including:
  - Procedures intended to ensure that PUDs are claimed only for locations where a final investment decision has been made and where it can demonstrate that "reasonable certainty" criteria has been met; and
  - Processes by which changes to previously adopted development plans for PUDs are taken into consideration when determining whether the current year's PUDs meet the reasonable certainty criteria.

    In response, the company provided detailed explanations, including a reconciliation of the reserves quantities removed each year to the corresponding year those volumes had been initially disclosed. The company also noted negative revisions to certain of its locations in 2012 that had been based on comparatively unfavorable well economics of those locations when compared with new PUD locations it had acquired during that year (*Atlas Resource Partners, L.P.*).

- In response to a staff comment about a company's low annual conversion rate for its PUDs over the prior five years, the company cited a number of factors that had contributed to the low rate, in addition to its lack of adherence to its previously adopted development plans. The staff asked the company to describe its internal controls used in estimating its reserves to illustrate the steps taken by management to ensure there was reasonable certainty in proceeding with its development plans. In response, the company informed the SEC that going forward, it intended to further strengthen the review and monitoring of the PUD drilling schedule, including providing quarterly progress reports to the Board specifically on PUD drilling relative to the schedule in the reserves report and a specific review by the Audit Committee of the previous year's PUD conversion performance when approving the annual reserves report. In addition, the company agreed to include additional disclosure related to such internal controls in its upcoming 10-K (*Energy XXI Ltd.*).

  Additional Disclosures Provided in 2014 Form 10-K:

  - *Proved undeveloped property drilling (and/or development) schedules are reviewed and approved by the Audit Committee and certain members of senior management.*
  - *Senior management regularly reviews the Company's drilling schedule and, after consultation and updates from the respective departments of the Company, approves any changes made to the existing long range plan ("LRP") and the related development plan. In addition, a comparison of actual proved undeveloped properties drilled (or developed) versus the associated previous fiscal year-end reserve report schedule is reviewed by the Board on a quarterly basis. This information is considered prior to approval of the current fiscal-year development schedule and associated reserves estimates.*

- In its review of a company's 2014 annual report, the staff noted that the drilling schedules for a significant majority of PUD locations that had been included in its 2012 and 2013 reserves had been changed at least once, and in some cases up to four times, over the periods such locations had been included as booked PUDs. The staff also observed that in each of 2011, 2012 and 2013, the company's development activity with respect to its PUDs, expressed as a percentage of total PUD volumes disclosed as of the beginning of that fiscal year, had been very low. The staff also noted that the information provided to the company's audit committee upon completion of the company's year-end reserve report had been inadequate, because the information addressed only high-level material changes in the development plans. In response, the company agreed to enhance its internal controls and clarify in specific detail for its audit committee and its board of directors any expected material changes to its PUDs resulting from development plan changes, including an accounting of PUD locations that were deferred or written off as a result of those changes. The company further stated that its reserve engineers and operations personnel had been instructed to (i) track material changes in PUD locations each time the company's development plan changed and (ii) provide that information to management and the board for their review (*Penn Virginia Corp*.).

PUD Conversion Rates and Causes of Year-to-Year Revisions in Proved Reserves. Another topic that drew considerable staff comments in 2014 and 2015 was how companies were disclosing year-to-year changes in their proved reserves and particularly in their PUDs. If a company's disclosed annual rates of converting its PUDs to proved developed reserves ("**PDs**") did not appear to support the proposition that all of the company's PUDs will be developed in five years, the staff frequently issued comments requesting further explanation.

For example, where one company's conversion rate had been 6 percent in 2013, and the combined rates over the prior three years had aggregated 33 percent, the staff asked the company to submit an analysis of deviations in drilling progress from the schedules it had adopted when first booking those reserves and an explanation of how it expected to remain on schedule to convert all PUD reserves within five years of initial booking.

In response, the company stated that the principal reason for the low conversion rates was its shift in concentration from drilling vertical wells to drilling horizontal wells. It explained that approximately 75 percent of its PUDs as of December 31, 2011 had been planned as vertical wells, which had since that date either been drilled, removed or replaced, primarily by horizontal wells. It also said that the 2011 year-end PUDs included natural gas reserves attributable to its assets in the Anadarko Basin, and that as it had shifted its focus to more oil-rich Permian Basin assets, those Anadarko Basin PUDs were removed and eventually sold. (*Laredo Petroleum, Inc.*).

Paragraph 932-235-50-5 of Financial Accounting Standards Board Accounting Series Codification Topic 932 "Extractive Activities – Oil and Gas" (FASB ASC 932-235-50-5) requires tabular disclosure of significant changes in the net quantities of an E&P company's proved reserves that occur each fiscal year, broken down by the specific causes for those changes (See *Emerald Oil, Inc.*; *Royal Dutch Shell plc*; *Isramco, Inc*. for examples of such tabular disclosure). Under FASB ASC 932-235-50-5, separate line item disclosures are required for changes in net quantities of proved reserves resulting from (i) revisions of prior estimates, (ii) application of improved recovery techniques, (iii) purchases and sales of properties, (iv) production and (v) extensions and discoveries, along with an appropriate textual explanation of significant changes.

Item 1203(b) of the SEC's Regulation S-K also requires disclosure of material changes in PUDs during the prior year, including information concerning the quantities of PUDs converted into PDs. The disclosure must be accompanied by a discussion of the investments and progress made during the year to convert PUDs into PDs, including capital expenditures.

The staff issued numerous comments that many companies' tabular presentations of the changes in reserves had improperly aggregated amounts attributable to the different causal factors, and asked those companies to disaggregate those combined amounts and reconcile them by identifying and quantifying the extent of the separate causes (*Petrobras Argentina S.A.*; *Black Ridge Oil & Gas, Inc*.; *Eagle Rock Energy LP*; *Warren Resources, Inc*.; *Statoil ASA*).

Other staff comments observed certain changes in reserves from year to year and questioned why changes in other, unrelated items appeared to be inconsistent with the extent and direction of the changes in reserves. For example, where a company's PUDs increased 37 percent in one year, but the company had projected its future development costs to increase only 3 percent, the staff requested clarification (*Hydrocarb Energy Corp*.). In another instance, the staff requested an explanation where a company's estimated future development costs had decreased while its estimated PUDs quantities had increased (*Marathon Oil Corp*.).

Where companies reported material additions to their PUDs during the fiscal year, the staff asked the companies to disclose the technologies they used to establish reasonable certainty in support of those material additions, as required by Regulation S-K Item 1202(a)(6) (*Statoil ASA*; *Abraxas Petroleum Corp*.).

Concluding Remarks: Tips for Preparing Your 2015 Annual Report

After analyzing the SEC staff's comments that focus on its apparent major disclosure concerns in light of the current commodity price environment, E&P companies preparing their annual reports for the 2015 fiscal year should carefully consider the following suggestions:

- If a company anticipates that continued low commodity prices may result in further decreases in a company's proved reserves and impairments in the carrying values of its oil and gas properties during fiscal year 2016, it would be prudent to provide illustrative disclosures of projected write-downs based on year-end 2015 prices instead of the average of 2015's first-of-the-month prices.

- If the depressed-prices regime and other factors such as lower operating cash flows, restrictions on access to capital, debt service and other fixed costs will affect a company's plans for development of its proved properties in 2016, a company should describe in detail the effects of these factors on its capital expenditures and drilling plans, including how the company expects to develop its PUDs in a manner consistent with their schedule for development on which its reserves estimates are based.
- Changes in proved reserves and particularly in PUDs during 2015 should be described in detail according to the SEC rules and FASB guidance, particularly when PUDs reported as of year-end 2014 were removed from that category during 2015. The reasons for the removal of those PUDs and any additions of new PUDs as of year-end 2015 should be described in a manner that supports management's determination that the company's estimated PUDs, as of year-end 2014, had been reasonably certain to be economically producible and drilled within five years.
- If there has been considerable movement of locations into and out of a company's PUDs portfolio from year to year, the company should enhance the internal controls over its reserves estimation process by providing for additional senior management involvement and board oversight of changes in plans, and describe the changes in internal controls in its annual report.
- If a company's annual PUDs conversion rates have been anemic and are likely to remain that way, the company should provide additional disclosure about the reasons for the low rates and how the company has addressed and is addressing the question of whether the PUDs will be drilled within five years of their initial booking.
- Finally, consider providing additional disclosure if a company's business or operations could be materially impacted by prolonged low commodity prices as a result of borrowing base redeterminations, reduced access to capital, debt covenant compliance and hedging.

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