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January 12, 2018

Changing Outlook, Same Concerns: Key SEC Disclosure Topics in 2018 for E&P Companies

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Comment letters to oil and natural gas exploration and production (E&P) companies by the Division of Corporation Finance of the Securities and Exchange Commission (SEC) indicated several major areas of concern for the Division during 2017 regarding companies' disclosures. Many of the topics addressed were similar to those raised by the Division's staff in 2015-2016, but some were new, such as the staff's focus on non-U.S. E&P companies' impairment testing under International Financial Reporting Standards (IFRS). While 2017 saw some improvement in global and U.S. commodity prices and increasing demand for oil and gas, most of the staff's top concerns remain relevant for E&P companies preparing their annual, quarterly and current reports to be filed in 2018, as well as other public communications relating to their operations and financial condition.

Since 2008, when the SEC's oil and gas disclosure rules were overhauled, a principal overarching theme of staff comments has been the effect of various events and conditions on the timely development of companies' proved undeveloped reserves (PUDs). The comment letters publicly released by the SEC during 2017 indicate a continuing emphasis on this theme. Of note, the staff asked companies to:

- Provide additional details regarding the effects of their drilled but uncompleted (DUC) wells on future development plans
- Supply more details about the separate causes of the changes in net proved reserves quantities from year to year
- Explain why certain items had been included in (or excluded from) their calculation of the standardized measure of discounted future net cash flows (the "standardized measure")
- Comply with SEC guidance on the use of non-GAAP financial measures in public communications (including press releases and SEC filings)

In addition, other often-recurring comments included (i) requests for expanded disclosures on material trends and uncertainties affecting companies' results of operations, financial condition and reserves; (ii) accounting comments to companies using the successful efforts method of accounting for oil and gas producing activities; and (iii) comments on presentations of changes in companies' net proved reserves quantities.

Drilled but uncompleted (DUC) wells

Increase in companies' DUC wells. The depressed commodity price environment that began in the second half of 2014 not only caused many companies' properties to no longer be economical to develop, but also created constraints on development capital availability. Because of these conditions, many companies' plans to develop their PUDs had to be substantially curtailed, leaving substantial volumes of PUDs associated with wells drilled, but then suspended, shut-in or otherwise not completed. In 2017, the staff raised numerous questions about PUDs associated with these DUC wells, particularly whether those PUDs were still scheduled to be converted to proved developed status within five years from the dates of their initial disclosure.

Examples of comments related to how companies characterize their DUC wells include:

- Disclose the reserve quantities associated with your wells awaiting completion or resumption of drilling; identify whether they are classified as developed or undeveloped

- Quantify the reserve volumes of the PUDs associated with your DUC wells that will not be completed within five years of their initial disclosure
- If your capital expenditure budget was reduced assuming that prices would not improve, confirm that your development plan will still result in all PUDs relating to your DUC wells being converted to developed reserves within five years of their initial disclosure
- Provide additional detail regarding the planned timing and expected capital expenditures required to complete your DUC wells
- Disclose the number of gross and net DUC wells, associated reserve quantities and costs remaining for their completion; explain why their completion has been deferred
- If completion of any currently shut-in wells is dependent on forecasted future price improvements, quantify the volumes involved and address important economic factors or significant uncertainties regarding their completion schedule

PUDs associated with DUCs and the five-year rule. One company stated that it expected to develop approximately 60-70 percent of its total PUDs over the next three years, and that about 27.9 percent of its total PUDs were associated with DUC wells. The staff asked why the company had intentionally deferred completion of those wells, and whether any PUDs associated with the wells would not be converted to developed status within five years of their initial disclosure.

The company replied that completion of the DUC wells had been delayed due to cutbacks in its capital development program resulting from then-prevailing lower commodity prices. However, it contended that continued booking of the associated PUDs had been appropriate since all the DUC wells in question had been *drilled* within their respective five-year development windows, as the definition of “undeveloped reserves” under Regulation S-X Rule 4-10(a)(31)(ii) would appear to indicate.[1]

The staff responded that activities limited solely to drilling a well were not sufficient to fulfill the five-year timing requirement under the SEC’s definition of undeveloped reserves.[2] Because these drilled wells had not yet been completed, they did not satisfy the definition of “wells drilled” under Item 1205 of Regulation S-K, which requires disclosure of the net productive and dry exploratory and development wells drilled in each of the prior three fiscal years. Sub-section (b)(4) of Item 1205 provides, in relevant part, that “For purposes of this Item 1205 … [t]he number of *wells drilled* refers to *the number of wells completed* at any time during the fiscal year, regardless of when drilling was initiated” (emphasis supplied).

The staff also noted that the term “productive wells” was defined in Item 1208 of Regulation S-K (requiring disclosure of total gross and net productive wells as of year-end), as being “*producing wells and wells mechanically capable of production*” (emphasis supplied). [3] In the staff’s view, the company’s development efforts had been insufficient to bring the DUC wells’ associated PUDs to the status of being “economically producible,” and that they therefore failed to qualify as proved oil and gas reserves under Rule 4-10(a)(22) of Regulation S-X.

[1] SEC Regulation S-X Rule 4-10(a)(31)(ii) provides that “Undrilled locations can be classified as having undeveloped reserves *only if a development plan has been adopted indicating that they are scheduled to be drilled within five years,* unless the specific circumstances, justify a longer time.” (Emphasis supplied.) In its response to the staff, the company pointed out: “We note that all of our DUC wells are part of an adopted development plan, … under Rule 4-10(a)(31)(ii) of Regulation S-X. All DUC wells were drilled within the five year development window and as noted in our [prior responses], we are actively completing these wells as part of our 2016 capital program….”

[2] *Cabot Oil & Gas Corp*. (Jan. 11, 2017).

[3] Item 1208(c)(3) of Regulation S-K.

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Moreover, because development of the DUC wells' reserves had been intentionally delayed by the company based on its internal factors, the staff determined that an exception from the five-year rule was not merited.

Changes in annual reserve quantities and values

There were an increasing number of comments during 2017 on companies' disclosures of year-to-year changes in the total net quantities and the standardized measure of their proved reserves. Most prevalent among these comments were requests for expanded disclosures detailing the reasons for each separate cause of the total changes. Typical comments were as follows:

- Identify and quantify each factor that contributed to a significant change in total proved reserves; these factors should include changes resulting from extensions and discoveries, acquisitions, divestitures, changed commodity prices, revisions of previous estimates, improved recovery and conversions of PUDs to proved developed status
- To the extent that two or more unrelated factors contributed to a single line item change, indicate the amount attributable to each factor as part of your narrative explanation
- Descriptions of revisions to prior estimates of your reserve quantities should identify the separate factors triggering the revisions, such as well performance, uneconomic PUD locations or removals of locations due to modified development plans
- To the extent that newly-drilled infill wells within a section result in the recovery of additional reserves, but do not alter the extent of the prior proved area or the overall volumes available for drainage within that section, the changes in proved reserves relating to the infill wells should be classified as revisions, not as extensions or discoveries

Calculation of the standardized measure of discounted future net cash flows

The staff continued to show interest in how companies calculated their standardized measure. Comments focused on items that had been incorrectly excluded from the calculation and line items improperly aggregated that should have been presented separately. Examples included:

- Explain whether your costs related to a non-cancelable contract with a third party to reserve capacity for gathering and processing your produced natural gas are included in your calculations when determining the economic producibilty of your proved reserves
- Disclose whether the future development costs used in your calculation of the standardized measure include future abandonment or salvage costs
- Explain why per-well overhead expenses are excluded from your operated properties' projected production costs, and address the impact of including those expenses on your proved reserves

Greater scrutiny of press releases, current reports and non-GAAP financial measures

The staff has expanded the scope of its review in recent years of company disclosures in their quarterly earnings announcements, on their websites and at investor conferences. Most comments to E&P companies in 2017 regarding these filings and communications concerned the use of non-GAAP financial measures.

Briefly stated, a non-GAAP financial measure is defined by the SEC to be a numerical measure of historical or future financial performance, financial condition or cash flows of a company calculated in a manner (due to the inclusion or exclusion of certain items) that does not comply with GAAP. Earnings before interest, taxes,

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depreciation, depletion, amortization and exploration expenses, or EBITDAX, is an example of a common non-GAAP cash flow financial measure historically used by E&P companies.[4]

If a company employs a non-GAAP measure in its disclosures, it must (i) accompany that non-GAAP measure with a presentation having equal or greater prominence of the most directly comparable GAAP financial measure, and (ii) include a reconciliation of the differences between the non-GAAP measure and the most directly comparable GAAP financial measure.

To address concerns over public companies' increasing use of non-compliant non-GAAP measure disclosures in their filings, press releases and other public communications, the Division provided additional guidance in 2016.[5] In 2017, non-GAAP financial measures appearing in many E&P companies' disclosures continued to draw comments. The most common transgressions cited by the staff appeared to be companies' use of non-GAAP performance measures (such as adjusted net income or adjusted cash flows), many on a per share basis, that were not accompanied by the most directly comparable GAAP measure or any reconciliation.

In this regard, examples of non-GAAP financial measures prompting staff comments included the following:

- Net income (loss) adjusted for income tax benefit
- Cash flow from operations before changes in working capital
- Cash operating margins per Mcfe
- Net income adjusted for the effect of unrealized derivative gains on a per share basis
- Total revenues adjusted to exclude derivative settlements

Special measures of oil and gas reserve value, such as "estimated discounted future cash flow (PV-10) before tax expenses," are also non-GAAP financial measures. Any presentation of this type of reserves valuation measurement (i) must be accompanied by an equally prominent or more prominent presentation of the standardized measure of discounted future net cash flows, the most directly comparable GAAP-basis measure, and (ii) will require the inclusion of a reconciliation of that non-GAAP measure to the standardized measure.

Additional areas of staff focus

Other subjects that received considerable staff attention in 2017 included the following:

Comments to non-U.S. issuers. A number of comment letters issued to foreign private issuers, national oil companies and other non-U.S. registrants were publicly released by the SEC during 2017.[6] Issues raised in many of these comment letters were identical to those raised in recent years in comments directed to U.S. companies. For example, many non-U.S. filers were asked to disclose the likely effects of known trends or uncertainties relating to changing commodity prices affecting their liquidity, capital resources and reserves.

[4] For more thorough discussions on non-GAAP financial measures employed by E&P companies and comments from the staff, see *Top Five SEC Disclosure Issues for E&P Companies' 2016 Annual Reports; Get Your DUCs in Order* (Feb. 6, 2017), and *Falling out of the GAAP: Recent SEC Staff Comments on Energy Companies' Non-GAAP Financial Measures Disclosures* (Jan. 24, 2017).

[5] View the Division's Compliance & Disclosure Interpretations on Non-GAAP Financial Measures.

[6] These included *Statoil ASA* (Sept. 9, 2016), *Petrobras* (Sept. 27, 2017 and Sept. 1, 2016), *Canadian Natural Resources Limited* (July 24, 2107), *Sasol Ltd* (Apr. 29, 2016), *JX Holdings* (Aug. 29, 2016), *CNOOC Ltd* (Sept. 26, 2016), *China Petroleum & Chemical Co.* (Sept. 14, 2016), *Imperial Oil Ltd* (Sept. 9, 2016), *Eni SpA* (Aug. 4, 2017), *Ecopetrol S.A.* (July 17, 2017) and *Cenovus Energy Inc.* (Sept. 27, 2017).

However, the staff did issue extensive comments on non-U.S. companies' compliance with IFRS; several comments raised questions about companies' policies for impairment testing under IFRS, and how those policies were applied.

Successful efforts accounting method comments. Accounting comments in recent prior years appeared to be more directed to companies using the full cost method of accounting – often questioning the need for additional impairment testing throughout the fiscal year due to the method's periodic testing requirement. But by 2017, the staff had apparently shifted its focus to companies using the successful efforts method.

In one series of letters, the staff questioned a company's policy that it evaluated, for its impairment testing purposes, the carrying values of its proved properties at each "formation" level.[7] The company contended that because its asset groupings and operations were concentrated in three contiguous or proximate counties in Pennsylvania and Ohio, its identifiable cash flows were largely separate and discrete for its properties in each of the Marcellus, Utica and Upper Devonian formations. Accordingly, each such formation could be treated as the lowest level for which identifiable cash flows were largely independent of the cash flows of its other assets and liabilities.[8]

Contemplating 2018

Assuming more favorable market conditions for E&P companies continue in 2018, there should be additional opportunities for healthier companies to find development capital, develop their properties and acquire assets. That said, companies' PUD inventories and the timing of development of those PUDs are expected to remain on the staff's radar screen. Companies that reallocate development capital to prospects in more promising areas will likely be questioned about their DUC wells drilled during prior periods that remain uncompleted in fields having less favorable economics. Companies should also continue to expect questions about timetables for converting their PUDs attributed to locations on material leases and concessions that are scheduled to expire in a few years.

The staff will also likely continue to monitor the year-to-year changes in companies' net proved reserve quantities and their standardized measure calculations to ensure that these yardsticks clearly and correctly reflect companies' performance and any changed market conditions. Other potential staff focus areas in 2018 could be rising costs (due to higher prices for leases and oilfield services), over-leveraged balance sheets of companies that expand too rapidly and, of course, non-GAAP financial measures. E&P companies should bear in mind these and other areas of concern for the staff and provide compliant, granular disclosures in order to avoid substantive comments and having to amend their previous filings.

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[7] *Rice Energy, Inc*. (Sept. 20, 2016). The staff was skeptical of the company's contentions that grouping assets at the formation level resulted in geographical groupings and identifiable cash flows that were discrete for each formation, and requested more information supporting its position. *Rice Energy, Inc*. (Dec. 9, 2016)..

[8] It is unclear from the publicly-available subsequent correspondence between the staff and the company as to how this accounting issue was resolved. See *Rice Energy, Inc*. (Feb. 15, 2017). We note that Rice Energy's Form 10-K filed in 2017 for its fiscal 2016 stated that the company had performed its evaluation of the carrying values of its proved natural gas properties at "the lowest levels for which there are identifiable cash flows that are largely independent of other groups of assets by comparing estimated undiscounted cash flows to the carrying value and including risk-adjusted probable and possible reserves, if deemed reasonable." See "Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations — Critical Accounting Policies and Estimates — Natural Gas Properties*" in the Rice Energy, Inc. Form 10-K for the year ended December 31, 2016.