

## Top Five SEC Disclosure Issues for E&P Companies' 2016 Annual Reports; Get Your DUCs in Order

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February 6, 2017

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Comment letters issued in 2016 by the staff of the Division of Corporation Finance of the Securities and Exchange Commission (SEC) to reporting E&P companies relating to their 2015 annual reports continue, as in past years, to focus on disclosure issues such as the effects of low commodity prices and proved undeveloped reserves (PUD) conversion rates. However, several new focus areas have emerged in SEC comments that E&P companies should consider when preparing their 2016 year-end annual reports. In particular, the staff of the SEC has asked companies to:

1. Provide additional details regarding drilled but uncompleted (DUC) wells;
2. Explain lower projected development costs as compared to historical development costs and PUD development financing plans;
3. Provide more details on material trends in commodity prices affecting the company and the assumptions underlying impairment estimates;
4. Explain certain items included (or not included) in the calculation of the standardized measure of discounted future net cash flows; and
5. Explain their use of non-GAAP financial measures in their SEC filings and elsewhere and ensure compliance with recent SEC guidance.

### SEC focus on DUC wells

While the staff continued to ask questions regarding material changes in PUD reserves, PUD conversion rates, the impact of reduced capital budgets on PUD conversion, and whether or not PUDs have been on the books for more than five years, the staff seemed particularly interested in how companies are characterizing DUC wells. Examples of staff comments include:

- Revise to provide additional detail regarding the planned timing and expected capital expenditures to complete DUC wells.
- Explain treatment of DUC wells and whether they were included with converted PUDs.
- Quantify reserves added which are associated with drilled but uncompleted wells that are not scheduled to be developed within five years of the date of initial booking.
- Confirm the company has a development plan for proved undeveloped reserves associated with DUC wells that will result in their conversion to developed reserves within five years of initial disclosure.

### Projected PUD development costs and related financing

Notably, it appears that in 2016, the staff did not issue comments as it had in 2014 and 2015 questioning whether companies with successive year-to-year changes in their PUD development plans had, when booking those PUD reserves, met the required standard of reasonable certainty and final investment decision.

With respect to several E&P companies, the staff flagged lower projected total development costs per unit as compared to historical per unit development costs. The staff questioned plans to fund PUD development that appeared inconsistent with other statements in the annual report as well as actual cash flow from operations. Examples of staff comments include:

- Explain the basis for lower projected development costs where the historical unit development cost for PUDs is higher than the projected total development cost for total PUD reserves on a per-unit basis.
- Discuss plans to finance the development of PUDs considering the expected reduction in the company's borrowing base and the company's stated intention to use available liquidity to pay down credit facility debt.
- Provide additional information explaining the basis for the statement that cash flow from operations would be sufficient to finance the company's drilling development plan and to reduce borrowings under its credit facility where capital expenditures budgeted for the drilling of PUDs over the next three years greatly exceeded the amount actually expended to drill PUDs in the prior three years.
- Provide additional information explaining the company's expectations regarding the availability of debt and equity financing through the capital markets, specifically for PUD development and the restrictions and covenants associated with currently outstanding debt which limit the company's ability to incur additional indebtedness.
- Discuss the impact on cash management decisions of the fact that cash used for capital expenditures plus dividends exceeded cash flow from operations.

## **Material trends in commodity prices and impairments**

Comment letters issued in 2015 focused in depth on the impact of lower commodity prices on E&P companies' proved reserve estimates and potential future impairments, asking companies to quantify possible future effects. Where companies did quantify possible future effects in their 2015 annual reports, the staff in 2016 appeared to be digging deeper, asking if these were the company's actual expectations regarding future commodity prices (perhaps considering the disclosed hypotheticals as boilerplate) as well as for more discussion of the assumptions used in quantifying estimated impairments and reductions in proved reserves.

While the commodity price environment is currently not as gloomy as it was in 2015 and the first half of 2016, companies should still consider including a robust discussion in their Management's Discussion & Analysis of Financial Condition and Results of Operations (MD&A) on material trends in commodity prices and how these trends are expected to affect their future operations, financial condition and liquidity, and if appropriate, the quantities and values of their reserves. The discussion should include any anticipated impact on the company's future borrowing base redeterminations, access to capital, or capital expenditures. Examples of staff comments include:

- Revise disclosure to clarify, if true, that a 10 percent hypothetical decrease in commodity prices is based on the company's expectations for future commodity prices. Otherwise, revise to provide disclosure addressing known material trends in commodity prices and the reasonably likely impact these prices will have on reserve quantities.

- Given the MD&A disclosure requirement in Item 303 of Regulation S-K pertaining to the reasonable possible material effects associated with known trends and uncertainties, expand disclosure to quantify the reasonably possible near-term changes to the carrying value of the company's oil and natural gas properties, proved reserves and development plans if commodity prices remain at low levels, including a discussion of all the key factor assumptions used in quantifying these estimates.
- When at risk for impairment if estimated commodity revenues are lower, provide additional disclosure to address material implications of uncertainties associated with the methods, assumptions, and estimates underlying the process through which impairments are assessed, including short-term and long-term commodity price assumptions, the degree of uncertainty associated with key assumptions and potential events that management reasonably expects could negatively affect key assumptions.

### **SEC focus on calculation of the standardized measure of discounted future net cash flows**

Comment letters issued in 2016 show an increased staff interest in how E&P companies are calculating the standardized measure. Staff comments have focused on line items that are incorrectly excluded or aggregated and apparent inconsistencies in line items compared with other financial measures. Examples of staff comments include:

- Explain future development costs used to calculate the standardized measure considering recent changes in PUDs and development costs actually incurred.
- Revise to explain why future income taxes are \$0 and also why reconciliation of PV-10 to standardized measure is not equal.
- Provide detail supporting the assertion that the company would not be subject to income tax for the projected life of its reserves at price levels for that period.
- Describe how midstream costs are represented in the standardized measure.
- Explain why the standardized measure does not reflect producing well overhead that corresponds to the level and cost of field, region and headquarters supervision (engineering report noted that these expenses were excluded).
- Explain why abandonment costs are not included in the calculation of the standardized measure.

### **Focus on non-GAAP financial measures**

In May 2016, the SEC issued new Compliance & Disclosure Interpretations on non-GAAP financial measures to address concerns over public companies' increasing use of non-GAAP financial measures in their filings and press releases, on websites and at investor conferences. Subsequently, numerous E&P companies received comments from the staff addressing their presentation of non-GAAP financial measures, particularly in their earnings releases. For an analysis of this guidance and the staff's comments, please see ["Falling out of the GAAP: Recent SEC Staff Comments on Energy Companies' Non-GAAP Financial Measures Disclosures."](#)

Of course, companies should ensure that any use of non-GAAP financial measures in their annual report complies with the SEC guidance. Companies should also be aware, however, that the SEC will likely look at their earnings releases when reviewing their annual report. In conjunction with its

review of annual reports in 2016, the staff took the opportunity to simultaneously review earnings releases filed or furnished on Form 8-K for compliance with its non-GAAP financial measures guidance. In many cases, where a Form 8-K with an earnings release was filed after the first round of SEC comments, the SEC added a review of the earnings release and any other earnings releases filed in the interim in the staff's second or third round of comments.

If you have any questions about this topic, please contact a member of our [Capital Markets and Securities Practice Group](#).