

Technical Line

Accounting for DrillCo arrangements

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What you need to know

- ▶ Upstream oil and gas companies that enter into drilling participation arrangements with investors need to exercise judgment to determine whether the transactions should be accounted for as conveyances or borrowings in accordance with ASC 932, *Extractive Activities – Oil and Gas*.
- ▶ The evaluation should focus on the composition of the property conveyed and the amount of interest retained by the investor as well as the effects of common features, such as a cost cap for the investor, investor well substitution rights, the right to accelerate the reversion of interest and the investor's right to suspend drilling.
- ▶ Because of the judgment required and the accounting consequences, entities contemplating drilling participation arrangements with investors should carefully consider the financial reporting effects before executing an agreement.

Overview

Given the capital required for drilling and the risks involved, upstream oil and gas companies may contemplate entering into a drilling participation arrangement tied to a future drilling program, commonly referred to as a DrillCo arrangement, instead of using more traditional forms of financing, such as obtaining a loan or tapping the debt or equity markets. Before doing so, companies should consider how the terms of an arrangement may affect their financial reporting.

In a DrillCo arrangement, an upstream company receives capital from an investor to drill a specified property in exchange for the legal sale of a working interest in the property. The upstream company (seller) continues to operate the property, and the investor (buyer) is

responsible for its share of the costs incurred and is entitled to its share of production in proportion to its working interest.

While this structure is similar to other joint operations in which each party owns an undivided interest in the minerals to be extracted, the primary difference is that all or a portion of the investor's working interest in a DrillCo reverts (i.e., is transferred back) to the upstream company once the investor achieves a fixed rate of return called a hurdle rate that is specified in the arrangement (see illustration below).

This type of arrangement may be appealing to upstream companies looking to raise capital to explore and develop specific properties, especially if they are finding it challenging to obtain traditional forms of financing. It may also be appealing to upstream companies that are looking to manage cash flows and spread the risks inherent in exploration and development of oil and gas properties while preserving their long-term equity position in those properties.

For investors, DrillCo arrangements provide an opportunity to invest in specific properties that are operated by an experienced management team. The arrangements may also provide protection for investors in the event of a bankruptcy because they provide ownership of a real property interest in the assets. While most investors in DrillCo arrangements have historically been private equity (PE) firms, other entities may also participate. For example, some oil and gas infrastructure companies may also participate in these arrangements because they can benefit from increased transportation and processing volumes in addition to the other reasons mentioned.

In a DrillCo arrangement, all or a portion of the investor's working interest reverts to the seller after the investor realizes a fixed rate of return (i.e., the hurdle rate).

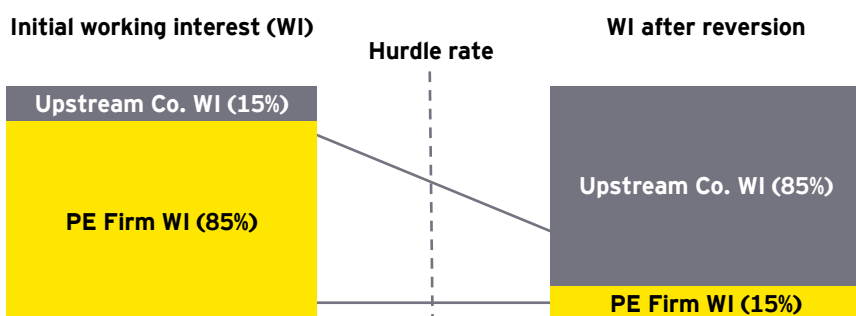
Key accounting and financial reporting considerations

While these arrangements are structured as legal conveyances of working interests in the properties subject to the arrangements, the presence of a contractual feature that requires all or a portion of the working interest owned by the investor to revert to the seller upon the realization of a fixed rate of return (i.e., the hurdle rate) raises questions about whether such an arrangement should be accounted for based on the legal form (i.e., a conveyance of a working interest) or as a borrowing.

Accounting Standards Codification (ASC) 932 provides a framework for entities with oil- and gas-producing activities to evaluate transactions involving the transfer of mineral interests. While it includes examples of conveyances and transactions that are in substance borrowings, it does not include an example of a DrillCo arrangement that looks like the illustration below.

Illustration 1 – DrillCo arrangement with a working interest that reverts to the upstream entity

Upstream Co. enters into a DrillCo arrangement with PE Firm under which PE Firm commits to provide up to a specified amount of capital to develop certain properties in a specified field. In exchange, PE Firm obtains an 85% working interest in the properties in a legal conveyance. A portion of that working interest reverts to Upstream Co. when PE Firm reaches a stated return or hurdle rate (e.g., once the investor obtains a 12% return on its investment in the aggregate).



However, ASC 932 includes an example of a pooling of assets in a joint undertaking (i.e., a type of conveyance) called a carried interest that resembles a DrillCo arrangement. Among other things, that example states, “A part of an operating interest in an unproved property may be assigned to effect an arrangement called a carried interest whereby the assignee (the carrying party) agrees to defray all costs of drilling, developing, and operating the property and is entitled to all of the revenue from production from the property, excluding any third party interest, until all of the assignee’s costs have been recovered, after which the assignor will share in both costs and production.”¹

ASC 932 also states that certain transactions referred to as conveyances are in substance borrowings repayable in cash or its equivalent and should be accounted for as borrowings. One example describes an arrangement in which funds advanced to an operator are repayable in cash from the proceeds from a specified share of future production of a producing property until the amount advanced plus interest at a specified or determinable rate is paid in full. The advance is accounted for as a payable by the recipient of the cash and a receivable for the party making the advance.²

The Basis for Conclusions (BC 220) of Statement of Financial Accounting Standards No. 19 explains why this type of transaction is in substance a borrowing. It states, “Normally, the advances are made by banks (often through an intermediary) or by other lenders under conditions that leave little doubt that the proved reserves are more than adequate to recover the funds advanced plus interest. The intent of the transaction is to obtain funds and not to sell oil or gas for future delivery. The recipient of the advance is at risk for any change in the price of oil or gas and for the cost of operating the property. The transaction is in substance a loan secured by reserves and is without recourse to other assets of the party receiving the advance.”

While neither of the transactions in these examples are identical to a DrillCo arrangement, they both share similarities with DrillCo arrangements and are the most analogous guidance available to consider. Therefore, these two examples are generally used in practice to determine whether the arrangement is more like a pooling of assets in a joint undertaking that should be accounted for as a conveyance or more like a financing arrangement that should be accounted for as a borrowing.

How we see it

ASC 932 applies to all entities with oil- and gas-producing activities,³ regardless of whether those activities are their primary operations. For this reason, the framework provided in this publication applies to an upstream company (seller), regardless of whether it is an operator or non-operator, and also generally applies to an investor (buyer).

Investors that conclude that conveyance accounting is appropriate should consider whether they need to make disclosures required by ASC 932 about their investments in oil and gas properties, including reporting on oil and gas reserves.

Applying the guidance

When a seller determines whether a DrillCo arrangement is more like a conveyance or a borrowing, the seller should assess whether both the risks absorbed by the investor and the variability in returns available to the investor are more like those of working interest owners in a joint undertaking or more like those of a creditor in a borrowing arrangement. The Securities and Exchange Commission (SEC) staff has also commented on the importance of carefully evaluating all of the relevant facts and circumstances of each individual transaction when evaluating whether a DrillCo arrangement is more like a conveyance or a borrowing.

A high likelihood that the investor will reach the stated hurdle rate suggests the arrangement is more debt-like, and high uncertainty about whether the investor will reach the hurdle rate suggests that the risk borne by the investor is more akin to that of a working interest owner in a joint undertaking. Similarly, potential returns above the stated rate that are limited suggest that the arrangement is more debt-like, while return potential that significantly exceeds the stated rate suggests the arrangement is more like that of a working interest owner. When analyzing these arrangements, companies should carefully evaluate the contractual terms and the effect they have on the arrangement.

To determine the likelihood of the investor reaching the stated hurdle rate and the potential upside for the investor after its interest reverts to the upstream company, companies may need to perform a quantitative analysis that contemplates different price and volume forecasts, based on geological and engineering data about the underlying properties and the risks associated with the extraction techniques.

The graphic below lists some common DrillCo features and shows whether each feature indicates that the arrangement should be accounted for as a conveyance or a borrowing.

Conveyance	Feature	Borrowing
Significant	Interest retained by the investor	Not significant
Unproved properties	Composition of the property conveyed	Producing properties
Low	Likelihood of reaching investor's cost cap	High
Not included	Investor well substitution rights	Included
Not included	Right to accelerate reversion of interest	Included
Joint decision	Investor right to suspend drilling	Unilateral decision

Interest retained by the investor

The significance of the potential returns an investor will receive after all or a portion of its working interest reverts to the upstream company depends on the percentage working interest retained by the investor and the point in the life of the property that the hurdle rate is expected to be achieved. Although there are no bright lines, the lower the retained interest (e.g., less than 10% of the interest initially conveyed) and the later in the life of the property that the working interest is expected to revert (e.g., when remaining production is not expected to be significant), the less likely it is that the overall economics of the arrangement depend on the retained interest. The less important the retained interest is to the overall economics of the arrangement, the more this feature indicates that the arrangement should be accounted for as a borrowing.

By contrast, the higher the retained interest (e.g., more than 20% of the interest initially conveyed) and the earlier in the life of the property the working interest is expected to revert, the more likely the overall economics of the arrangement depend on the retained interest. The more important the retained interest is to the overall economics of the arrangement, the more this feature indicates that the arrangement should be accounted for as a conveyance.

To evaluate the risks absorbed by the investor and the returns available to the investor, an entity must understand the composition of the property conveyed.

How we see it

The example of a conveyance that is in substance a borrowing in ASC 932-470-25-1(b) focuses on the downside risk of the arrangement. That is, it focuses on the likelihood that the investor will recover the funds advanced, plus interest that is “specified or determinable.” This reference to specified or determinable interest indicates that the potential upside of the arrangement should also be considered to determine whether an arrangement is more akin to a conveyance or a borrowing, as does our experience and our understanding of SEC staff views. Therefore, a wide range of possible returns (both positive and negative) would indicate that an arrangement does not have a determinable rate of return and should be accounted for as a conveyance.

Composition of the property conveyed

Understanding the composition of the property conveyed by the arrangement is a key factor in assessing the reserve and development risk borne by the investor and whether that risk is more indicative of a conveyance or a borrowing. In assessing these risks, entities should consider the reserve category of the properties conveyed. Properties are broadly categorized as proved (proved producing reserves or proved undeveloped (PUD) reserves) or unproved (probable reserves or possible reserves).

Entities should also consider the risk profile of the individual properties in each category. For example, when a property that is classified as probable is geologically and geophysically equivalent to a PUD property but cannot be classified as a PUD property solely because the entity cannot assert that it has made a final investment decision to develop the property within five years,⁴ an entity may conclude that the probable property has risk characteristics, including development risk, similar to a proved property.

While the carried interest example in ASC 932 involves unproved property, a DrillCo arrangement that involves a mix of proved and unproved properties could be accounted for as a conveyance if sufficient risk is borne by the investor. While there are no bright lines, as the amount of proved reserves in an arrangement increases, the reserve risk borne by the investor decreases, making it more likely that the arrangement should be accounted for as a borrowing.

Likelihood of reaching investor's cost cap

Each party to a sale of a working interest is generally required to pay its share of the cost of developing and operating the specified property and is entitled to its working interest share of production. However, certain DrillCo arrangements set a cost cap for the investor that either reduces its share of costs that exceed a specified amount or limits its costs to a predefined capital commitment that is based on the project's budget. This feature limits the development risk borne by the investor and increases the likelihood that the investor will reach the hurdle rate. In effect, it may allow an investor to receive its full working interest share of production without paying its full share of costs.

To evaluate a cost cap, an entity might consider whether a particular cap provides more protection for an investor in a DrillCo than a similar feature in a joint operating arrangement (JOA) that is accounted for as a conveyance. In JOAs, “caps” can take the form of a party's right to choose not to participate in the drilling of certain wells, which is commonly referred to as “going nonconsent.” When a party goes nonconsent, the cost to drill the wells is borne by the remaining parties. Generally, the consenting party (or parties) recovers its expenditures, plus a markup stated in the agreement, that is paid from the nonconsenting party's share of production. After the consenting party has recovered these amounts, the nonconsenting party participates in the revenues and expenses based on its working interest.

When an entity evaluates a cost cap, the greater the likelihood that the cost cap will be reached and will benefit the investor, the more the feature indicates that the arrangement should be accounted for as a borrowing.

Investor well substitution rights

Some DrillCo arrangements include a feature that allows the investor to substitute new wells for certain of the initially identified wells that fail to reach production. In a typical substitution provision, the legal working interest in the original well reverts to the upstream company (seller) when the investor substitutes a new well. These features reduce the investor's risk in the arrangement and effectively provide the investor with recourse to assets that were not part of the original legal transfer of the working interest.

The ability to substitute wells that did not reach production also can be viewed as a guarantee that the investor will have access to producing properties and, in turn, leaves little doubt that the reserves are more than adequate to recover the funds advanced, plus interest. For these reasons, well substitution rights are a strong indicator that the arrangement should be accounted for as a borrowing.

Right to accelerate reversion of interest

Some DrillCo arrangements include a feature that gives the seller the right to accelerate reversion of interest, typically by paying the investor (buyer) its original investment plus the agreed-upon hurdle rate (in effect, a call option held by the seller) or by providing the investor with the right to require the seller to repurchase its working interest (in effect, a put option held by the buyer). The right to accelerate reversion through a call option held by the seller or certain put options held by the buyer is a strong indicator that the mineral interests were not transferred to the investor (buyer) for accounting purposes, and the arrangement should be accounted for as a borrowing.

How we see it

Because ASC 932 does not specifically address a conveyance arrangement in which the seller has the right to repurchase its working interest or the investor has the right to require the seller to repurchase its working interest, an entity should consider other accounting guidance by analogy to analyze the effects of these features on the arrangement.

Examples of other US GAAP topics that include guidance on assessing whether control has transferred in arrangements with similar features include:

- *ASC 606, Revenue from Contracts with Customers*
- *ASC 610-20, Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*
- *ASC 860, Transfers and Servicing*

Under ASC 606, a transaction that includes a seller option to repurchase the product is not treated as a sale because the customer does not have control over the product and is constrained in its ability to direct the use of, and obtain substantially all the benefits from, the good. In addition, entities will need to carefully consider the terms of put options held by the customer to determine whether control of the asset has transferred. Similar guidance is included in both ASC 610-20 and ASC 860.

By analogy, call options held by the seller and put options held by the buyer should be considered in the accounting analysis and could preclude conveyance accounting, depending on the terms.

Investor right to suspend drilling

DrillCo arrangements may provide the investor with the unilateral right to suspend the drilling of new wells if commodity prices fall below a stated price. This feature serves to limit the price risk borne by the investor related to future capital spending for wells that have not yet been drilled (i.e., capital already spent remains at risk to changing commodity prices). While the right to suspend drilling is a protective right provided to the investor, the investor only benefits if the operator would have chosen to continue drilling at the stated price if the investor were required to continue financing the project.

To evaluate the effect of such a feature, the upstream company (seller) must consider whether a prudent operator would suspend drilling based on its assessment of the economics of continued drilling at the price stated in the agreement. If it is unlikely that the upstream company would continue drilling at the stated price, this provision may not be significant to the evaluation of whether the transaction should be accounted for as a conveyance or a borrowing. However, the greater the likelihood that the upstream company would choose to continue drilling at the stated price if the investor were required to continue financing the project, the more this feature would indicate that the transaction should be accounted for as a borrowing.

Disclosures

Entities that enter into DrillCo arrangements that are significant to their financial statements should consider disclosing information about the transaction in both their financial statements and other sections of their SEC filings (e.g., description of business, risk factors, management's discussion and analysis), regardless of whether they conclude that the transaction should be accounted for as a conveyance or a borrowing. This might include information about the nature and terms of the arrangement, the significant judgments applied in determining the appropriate accounting treatment, the amount of interest retained by the seller, the potential for properties to revert to the seller upon reaching the stated hurdle rate and the effect on proved oil and gas reserves. The SEC staff has encouraged clear and transparent disclosures.

Endnotes:

- ¹ ASC 932-360-55-5.
- ² ASC 932-470-25-1.
- ³ ASC 932-10-15-2 and 15-2A.
- ⁴ Rule 4-10(a)(31)(ii) of Regulation S-X states that undrilled locations can be classified as having proved undeveloped reserves only if the development plan has been adopted and indicates that the undrilled locations are scheduled to be drilled within five years, unless the specific circumstances justify a longer period of time.

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