

APPLICATION OF AMERICAN COASTAL ENERGY, INC., TO CONSIDER REDUCTION OF THE AMOUNT OF FINANCIAL ASSURANCE REQUIRED PURSUANT TO STATEWIDE RULE 78(g) FOR VARIOUS LEASES IN RAILROAD COMMISSION DISTRICTS 2 AND 3, CALHOUN COUNTY, TEXAS

APPEARANCES:

FOR APPLICANT:

Matt Sjoberg
David McCarver

APPLICANT:

American Coastal Energy, Inc.

PROPOSAL FOR DECISION

PROCEDURAL HISTORY

DATE OF REQUEST FOR HEARING:	September 24, 2004
DATE OF NOTICE OF HEARING:	October 28, 2004
DATE OF HEARING:	November 15, 2004
HEARD BY:	James M. Doherty, Hearings Examiner
DATE RECORD CLOSED:	November 29, 2004
DATE PFD CIRCULATED:	December 28, 2004

STATEMENT OF THE CASE

This is the application of American Coastal Energy, Inc. ("ACE") filed pursuant to Statewide Rule 78(g)(5) for a reduction in the amount of financial security required for ACE's offshore wells. The application is unopposed. A hearing was held on November 15, 2004, and ACE appeared and presented evidence. At the request of ACE, the record was held open until November 29, 2004, for the filing of additional documentary evidence.

APPLICABLE RULES

Statewide Rule 78(g)(3) requires the filing of additional financial security for offshore wells. As relevant here, in addition to other financial security required under Rule 78(g)(1), an operator of offshore wells must file entry level financial security of \$100,000 and an additional \$100,000 for each

inactive offshore well in excess of one.

Rule 78(g)(5) provides that an operator of bay and/or offshore wells may request the Commission to consider a reduction in the additional financial security requirement for inactive offshore wells. The Rule 78(g)(5) reduction may not exceed 25% of the operator's certified and independently audited net worth for the most recently completed fiscal year less the Commission's estimate of the operator's plugging liability for all active bay and/or offshore wells.

Under Rule 78(g)(5)(A), a reduction may be approved administratively if: (1) the operator has either five or fewer bay and offshore wells or at least one-half of the operator's bay and offshore wells are producing; (2) the operator provides certification of net worth from an independent auditor who has employed generally accepted accounting principles; (3) the reduction does not exceed 25% of the operator's certified net worth less the Commission's estimate of the operator's plugging liability for all active bay and offshore wells; and (4) the operator's wells have not been found by Commission staff to be violating or to have violated any Commission rule that resulted in pollution or in any hazard to the health and safety of the public in the last 12 months. If a requested reduction is denied administratively, the operator may request a hearing to determine if a reduction should be granted.

BACKGROUND

The Form P-5 Organization Report of ACE was most recently due to be renewed on September 1, 2004. On September 20, 2004, ACE sent a letter to the Commission's P-5/Financial Assurance Unit requesting a reduction in required financial security for ACE's offshore wells, enclosing a list of the offshore wells and July 31, 2004, financial statements.

On September 24, 2004, the P-5/Financial Assurance Unit sent ACE a letter stating that the request for reduction could not be approved administratively because: (1) ACE is not an operator of five or fewer bay and offshore wells and more than one-half of ACE's offshore wells are inactive; and (2) based on the July 31, 2004, financial statements, ACE had a negative net worth. On September 24, 2004, ACE requested a hearing as permitted by Rule 78(g)(5)(B).

DISCUSSION OF THE EVIDENCE

The examiner has officially noticed Commission "On-Schedule Leases, Wells, Wellbores By Operator" records showing that as of the date the record closed, ACE was the operator of 47 wellbores, of which 20 are land based and 27 are offshore. These wellbores had total depth of 393,614 feet.

Evidence presented at the hearing disclosed that, as of the date of the hearing, 19 of ACE's 27 offshore wells were inactive. Based on this number of inactive offshore wells, ACE's total financial security requirement is \$1,950,000. This total is comprised of financial security required by Rule 78(g)(1) in the

amount of \$50,000, entry level financial security required of operators of offshore wells by Rule 78(g)(3)(A) in the amount of \$100,000, and additional financial security required for inactive offshore wells (in excess of one) by Rule 78(g)(3)(B) in the amount of \$1,800,000. According to ACE, two of the wellbores classified by the Commission as inactive have been returned to production, although as of the date of the hearing, these wellbores had not yet produced a sufficient volume of hydrocarbons for three consecutive months to be restored to active status on records of the Commission. ACE asserted that one additional wellbore classified by the Commission as inactive has been plugged. If the two producing wellbores are restored to active status, and the plugged wellbore is removed from ACE's inactive well listing, ACE's Rule 78(g)(5)(B) financial security requirement would be reduced by \$300,000.

ACE is in the business of acquiring "marginal" properties. It attempts to enhance productivity and extend the economic life of wells that it acquires. ACE believes that its request for a reduction in financial security does not fit neatly any of the reduction provisions of Statewide Rule 78(g)(5), and concedes that if the rule is applied strictly, ACE is not entitled to a reduction. Thus, ACE requests that the Commission consider a "different approach" to ACE's requested reduction.

All of ACE's offshore wells are located on State tract leases. Some of these leases are held by production, but according to ACE, three or four of the leases have terminated, apparently based on a cessation of production. ACE expects to renominate the terminated leases with the intention of reacquiring them.¹

ACE asserts that in determining the amount of supplemental bonds required under 30 CFR §256.53(d) and (e) for operators of Federal oil, gas, and sulphur leases in the Outer Continental Shelf, the Minerals Management Service ("MMS") of the United States Department of the Interior will consider 50% of the operator's proved producing reserves² in the calculation of the operator's net worth, where the operator submits: (1) an independent third-party estimate of total producing reserves, including a reserve report breaking down proved producing reserves on a lease, reservoir and well completion basis and a cash flow spreadsheet to show anticipated production, expenses, and cash flow; (2) reservoir depth structure maps, and net sand and oil/gas isopach maps; (3) production information for all producing wells for the last 12-month period; (4) well test information for the last 12-month period for all producing wells; and (5) reservoir bottom-hole pressure information, including the well the pressure was recorded in, the date the pressure was recorded, the depth in MD and TVD of the recorded pressure and the calculated bottom-hole pressure corrected to reservoir datum depth.

¹ Presumably, if these leases are "nominated," they will be put up for public bid, and there is no assurance that ACE will be the successful bidder.

² Proved reserves are those quantities of petroleum which, by analysis of geological and engineering data, can be estimated with reasonable certainty to be commercially recoverable, from a given date forward, from known reservoirs and under current economic conditions, operating methods, and government regulations. Reserves subcategorized as "producing" are expected to be recovered from completion intervals which are open and producing at the time of the estimate.

At the hearing, ACE presented a preliminary report (subject to revision and to conditions in a final report) of “before Federal income tax economics” reserves of ACE as of November 1, 2004, prepared by an independent third party, T. J. Smith & Company, Inc. From this report, ACE asserted that it has proved developed producing reserves with a ten percent discounted net revenue value of \$15,053,200, and took the position that under Minerals Management Service criteria, 50% of this reserves value would be included in MMS’ calculation of ACE’s net worth.

An unaudited July 31, 2004, balance sheet for ACE submitted to the P-5/Financial Assurance Unit, in support of the request for a reduction in financial security, included as an asset ACE’s oil and gas properties at cost, including “Leasehold costs” of \$7,477,183. This balance sheet did not, however, include as an asset any proved producing reserves item, separate from the leasehold costs asset. The July 31, 2004, balance sheet reflected that on a modified cost basis, ACE had a negative net worth.

At the hearing, ACE presented a September 30, 2004, balance sheet, which Ace said was “not your typical balance sheet.” Attached to this balance sheet was a letter directed to ACE’s directors by ACE’s Treasurer, stating that the balance sheet had been compiled on a modified cash basis in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The letter explained that the modified cash basis on which the balance sheet had been prepared was “a comprehensive basis of accounting other than generally accepted accounting principles.” The letter explained further that the ACE financial statements had not been audited or reviewed, so that no expression of opinion or any other form of assurance should be made on them. According to the letter, management had elected to omit substantially all of the disclosures ordinarily included in financial statements prepared on the modified cash basis of accounting, and if such disclosures were included, they might influence the user’s conclusions about ACE’s assets, liabilities, stockholders’ equity, income and expense.

Unlike the July 31, 2004, balance sheet submitted by ACE to the P-5/Financial Assurance Unit, the September 30, 2004, balance sheet included in Stockholders’ Equity an item described as “Unrealized increase in O&G Properties as per Proven Reserve Value a/o 11-1-04” in the amount of \$22,231,357. This balance sheet showed that at September 30, 2004, ACE had a deficit in retained earnings of \$3,088,209, but with inclusion of the “Unrealized increase in O&G Properties as per Proven Reserve Value a/o 11-1-04” item, Total Stockholders’ Equity was shown as \$19,243,148. The July 31, 2004, balance sheet submitted to the P-5/Financial Assurance Unit had shown a deficit in retained earnings of \$2,912,704 and a deficit in Stockholders’ Equity of \$2,812,704.³

The September 30, 2004, balance sheet for ACE included under Long Term Debt an Accrued Abandonment Liabilities item in the amount of \$2,835,000, which ACE described as an item and amount

³ A Statement of Income and Expense-Modified Cash Basis for the nine months ended September 30, 2004, showed that for this period, ACE had a net loss of \$2,058,545.

dictated by generally accepted accounting principles.

At the request of ACE, the record was held open to receive additional documentation relating to ACE's reserves. On November 29, 2004, ACE filed a more detailed report of "Reserves and Future Net Revenues Using Instructed Prices and Costs As of November 1, 2004" prepared by T. J. Smith & Company, Inc., oil and gas consultants. A T. J. Smith November 22, 2004, letter to ACE accompanying the report, which explains the scope and methodology of the report, is attached to this proposal for decision as Appendix 1. Table I in the report, "Before Federal Income Tax Economics - Reserves As Of November 1, 2004" is attached to this proposal for decision as Appendix 2. Consistent with the reserves report presented at the hearing, the more detailed report purports to show that ACE has proved developed producing reserves with a ten percent discounted net revenue value of \$15,053,200.

The material filed by ACE on November 29, 2004, also included what appear to be files containing work papers used by T. J. Smith in compiling the reserve report. Papers in these files appear to include production histories, decline curves, reserve calculations, and the like.

ACE asserts that because of the "low apparent value" of ACE's "late-life" properties and "accounting constraints imposed on operators of these properties," ACE's financial statements do not reflect the true value of the company or accurately portray ACE's ability to meet financial obligations concerning plugging of wells. ACE requests that the Commission consider a percentage of proved producing reserves in evaluating ACE's net worth, as it bears on entitlement to a reduction of required financial security pursuant to Rule 78(g)(5). ACE stated a willingness to file the \$50,000 of financial security required by Rule 78(g)(1) and the entry level financial security of \$100,000 required of operators of offshore wells by Rule 78(g)(3)(A). ACE believes, however, that it would not be required to file any additional financial security under rules and standards of MMS, and requests that the Commission follow the same standards.

EXAMINER'S OPINION

The application of ACE for a reduction in additional financial security required by Rule 78(g)(3)(B) should be denied. To support a request for reduction of this type, the applicant is required to provide certification of net worth from an independent auditor who has employed generally accepted accounting principles. The financial statements presented by ACE are not certified by an independent auditor, are not audited statements, and are not statements compiled according to generally accepted accounting principles. In fact, the letter of ACE's Treasurer appended to ACE's financial statements indicates that the statements are compiled on a modified cash basis of accounting, which is a basis of accounting *other* than generally accepted accounting principles.

The Railroad Commission has not adopted the same rules and standards as are applied by MMS to financial security required for operators of Federal oil, gas, and sulphur leases in the Outer Continental Shelf. Rule 78(g) contains no express provision authorizing the examiner to consider a percentage of the

estimated value of proved producing reserves in the calculation of ACE's net worth.⁴ Whether the value of proved producing reserves *should* be a consideration is a policy question for the Commissioners, not for the examiner.⁵ There is no proof in this case that generally accepted accounting principles permit consideration of the estimated value of proved producing reserves in calculation of ACE's net worth, and without such consideration, ACE has a negative net worth. Considering the number of ACE's offshore wells which were, at the time of the hearing, considered by the Commission to be active, ACE would need an independently audited and certified net worth in excess of \$3,200,000 to be entitled to any amount of Rule 78(g)(5) reduction in the additional financial security required by Rule 78(g)(3).

ACE's own financial statements reflect that ACE has a well abandonment liability of \$2,835,000, almost \$1,000,000 *more* than the financial security required of ACE by Statewide Rule 78(g). The \$50,000 of financial security required by Rule 78(g)(1) and the \$100,000 of entry level financial security required by Rule 78(g)(3)(A) appear to be wholly inadequate financial security to cover the Commission's estimate of ACE's well plugging liability, an estimate which is not challenged by ACE. The examiner recommends that ACE's application for a reduction in the additional financial security required by Rule 78(g)(3)(B) be denied.

Based on the record in this case, the examiner recommends adoption of the following Findings of Fact and Conclusions of Law.

FINDINGS OF FACT

1. At least ten (10) days notice of the hearing in this docket was sent to all parties entitled to notice. American Coastal Energy, Inc. ("ACE"), appeared at the hearing, and presented evidence.
2. By the application in this docket, ACE requests, pursuant to Statewide Rule 78(g)(5), a reduction in the amount of additional financial security for ACE's inactive offshore wells required by Statewide Rule 78(g)(3).

⁴ ACE's assertion that under MMS rules and standards, it would not be required to file additional financial security is doubtful, because ACE's financial statements are not independently audited or certified and not proved to have been compiled according to generally accepted accounting principles. Furthermore, it appears from the Supplemental Bond Procedures of MMS that considerably more information than has been supplied to the Railroad Commission would be required by MMS to support a request for MMS consideration of proved producing reserves in calculation of a lessee's net worth.

⁵ While "proven producing reserves" is apparently the most reliable of "reserves" categories, the fact that ACE states that it is in the business of acquiring "marginal" properties and, according to ACE, three or four of ACE's State tract leases have terminated, leads to some lack of confidence in ACE's reserves as a basis for a net worth reduction in required financial security, particularly since cessation of production is the most common cause of lease termination and, at the time of the hearing, 70% of ACE's offshore wells were considered by the Commission to be inactive.

3. As of the date the record closed, ACE was the designated operator of 47 wellbores, of which 20 were land based and 27 were offshore. These wellbores had total depth of 393,614 feet. Of the 27 offshore wells, 19 were considered by the Commission to be inactive. At the hearing, ACE represented that it was in the process of restoring two of the inactive offshore wells to active status, and one of the offshore wells considered by the Commission to be inactive had been plugged.
4. Based on the number of ACE's offshore wells considered by the Commission to be inactive at the time of the hearing, ACE's total financial security requirement under the provisions of Statewide Rule 78(g) is \$1,950,000, comprised of financial security required by Rule 78(g)(1) in the amount of \$50,000, entry level financial security for operators of offshore wells required by Rule 78(g)(3)(A) in the amount of \$100,000, and additional financial security for inactive offshore wells (in excess of one) required by Rule 78(g)(3)(B) in the amount of \$1,800,000.
5. ACE is in the business of acquiring "marginal" oil and gas properties and attempting to enhance their productivity and extend their economic life. All of ACE's offshore wells are located on State tract leases. Some of ACE's State tract leases are held by production, but three or four of them have terminated.
6. The Form P-5 Organization Report of ACE has been delinquent since September 1, 2004. On September 20, 2004, pursuant to Rule 78(g)(5), ACE sent a letter to the Commission's P-5/Financial Assurance Unit requesting a reduction in the additional financial security required by Rule 78(g)(3)(B), and submitted therewith July 31, 2004, financial statements for ACE.
7. On September 24, 2004, the Commission's P-5/Financial Assurance Unit sent ACE a letter stating that ACE's request for a reduction in additional financial security could not be approved administratively because: (a) ACE was not an operator of five or fewer bay and offshore wells and more than one-half of ACE's offshore wells were inactive; and (b) based on ACE's July 31, 2004, financial statements, ACE had a negative net worth.
8. On September 24, 2004, ACE requested the hearing in this docket, as permitted by Rule 78(g)(5)(B).
9. ACE did not provide the Commission with certification of its net worth from an independent auditor who employed generally accepted accounting principles.
 - a. The July 31, 2004, and September 30, 2004, financial statements ("the ACE financial statements") provided to the Commission are unaudited statements and are not certified as having been compiled by use of generally accepted accounting principles.
 - b. The ACE financial statements were prepared on the modified cash basis of accounting, which is a comprehensive basis of accounting *other than* generally accepted accounting principles.
 - c. The ACE financial statements were compiled based on representations of ACE's

management and were not independently audited or reviewed. Management elected to omit substantially all of the disclosures ordinarily included in financial statements prepared on the modified cash basis of accounting, which, if included, might influence a user's conclusions about ACE's assets, liabilities, stockholders' equity, income and expense.

10. The ACE financial statements show that ACE has a negative net worth, unless the estimated value of ACE's proved producing reserves is considered in the calculation of net worth. ACE did not present any evidence that inclusion of the estimated value of proved producing reserves in the calculation of net worth is consistent with the use of generally accepted accounting principles.
11. The ACE financial statements show that at September 30, 2004, ACE had well abandonment liability in the amount of \$2,835,000. The Railroad Commission's estimate of ACE's well plugging liability for offshore wells is \$2,700,000.
12. Based on the number of ACE's offshore wells considered by the Commission to be active at the time of the hearing, to be entitled to any amount of reduction in the additional financial security required by Statewide Rule 78(g)(3) for inactive offshore wells, ACE is required to have net worth, certified by an independent auditor, in excess of \$3,200,000.

CONCLUSIONS OF LAW

1. Proper notice of hearing was timely issued by the Railroad Commission to appropriate persons legally entitled to notice.
2. All things necessary to the Commission attaining jurisdiction over the subject matter and the parties to this hearing have been performed or have occurred.
3. Pursuant to §91.103 of the Texas Natural Resources Code, any person, including any firm, partnership, joint stock association, corporation, or other organization, required to file an organization report under §91.142 of the Code must execute and file with the Commission a bond, letter of credit, or cash deposit.
4. Pursuant to §91.104 of the Texas Natural Resources Code, a person required to file a bond, letter of credit, or cash deposit under §91.103 of the Code who is an inactive operator or who operates one or more wells must, at the time of filing or renewing an organization report required by §91.142 of the Code, file an individual bond as provided under §91.1041 of the Code, a blanket bond as provided under §91.1042 of the Code, or a letter of credit or cash deposit in the same amount as required for an individual bond under §91.1041 of the Code or a blanket bond under §91.1042 of the Code.
5. Pursuant to §§91.1041(b) and 91.1042(b) of the Texas Natural Resources Code, the Commission

is authorized to set by rule the amount of the bond for an operator of bay and offshore wells at a reasonable amount that exceeds the amount provided by §§91.1041(a) and 91.1042(a) of the Code.

6. Operators of offshore wells are required to file with the Commission the amount of financial security provided by the Commission's Statewide Rule 78(g)(1) [16 TEX. ADMIN. CODE §3.78(g)(1)] and the additional amount of financial security provided by Statewide Rule 78(g)(3) [16 TEX. ADMIN. CODE §3.78(g)(3)].
7. Pursuant to the Commission's Statewide Rule 78(g)(5) [16 TEX. ADMIN. CODE §3.78(g)(5)], an operator may request that the Commission consider a reduction in the amount of additional financial security required by Statewide Rule 78(g)(3) not to exceed 25% of the operator's certified net worth based on the independently audited calculation for the most recently completed fiscal year minus the Commission's estimate of the operator's total plugging liability for all of the operator's active bay and offshore wells.
8. American Coastal Energy, Inc., failed to prove that it is entitled to a reduction, pursuant to Statewide Rule 78(g)(5), in the amount of additional financial security required by Statewide Rule 78(g)(3).
9. The application of American Coastal Energy, Inc., pursuant to Statewide Rule 78(g)(5) for a reduction in the amount of additional financial security required by Statewide Rule 78(g)(3) should be denied.

RECOMMENDATION

The examiner recommends that the application of American Coastal Energy, Inc., pursuant to Statewide Rule 78(g)(5), for a reduction in the amount of additional financial security required by Statewide Rule 78(g)(3) be denied.

Respectfully submitted,

James M. Doherty
Hearings Examiner