

September 7, 2004

Mr. Lawrence W. Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856-5116

Re: EITF Issue 04-G - Accounting for Suspended Well Costs

Dear Mr. Smith:

The Accounting Committee of the American Petroleum Institute (API) is pleased to provide information for consideration by the Emerging Issues Task Force (EITF) in its deliberations on Issue 04-G, *Accounting for Suspended Well Costs*, which was recently added to the Task Force's agenda.

Background

Statement of Financial Accounting Standards No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies* (FAS 19) requires the cost of drilling exploratory wells to be capitalized pending determination of whether the well has found proved reserves (paragraph 31). If classification of proved reserves cannot be made at completion of drilling in an area requiring a major capital expenditure, paragraph 31(a) requires the cost to continue to be carried as an asset providing that; (i) there has been sufficient reserves found to justify completion as a producing well if the required capital expenditure is made and (ii) drilling of additional exploratory wells is underway or firmly planned for the near future. For all other exploratory wells that find oil and gas reserves, paragraph 31(b) requires the capitalized costs to be charged to expense if the reserves cannot be classified as proved after a year following the completion of drilling.

In summary, the Board recognized that where major capital expenditures are required it might take longer than one year to determine proved reserves. This recognition is a substantive principle and was addressed in the Basis of Conclusions of FAS 19. In paragraph 199, the Board "concluded not to impose the one-year presumption of impairment on exploratory wells drilled in areas requiring a major capital expenditure before production could begin". However, the Board established the two conditions in paragraph 31(a) that must be present in order to apply this substantive principle of continued capitalization. The purpose of these conditions is to prohibit the indefinite deferral of these exploratory well costs on the hopes of increased prices or on the possibility that unplanned exploratory drilling might find additional reserves. The first condition that sufficient reserves have been found to justify completion as a producing well is normal practice in the oil and gas industry.

However, the second condition that drilling of additional exploratory wells must be underway or firmly planned for the near future has presented a challenge to the industry over the years because of how the business environment has evolved since FAS 19 was issued in 1977.

Much of FAS 19 was written from the general perspective of oil and gas exploration and development in the continental United States. For example, a trunk pipeline is the only example cited in paragraphs 31(a) and 199 as a major capital expenditure. In more recent years, trunk pipeline expenditures have represented a relatively small percentage of the billions of dollars spent on major exploration and development projects. This is because most of today's projects are in remote non-U.S. onshore areas or in worldwide offshore deep water. Large commitments for construction of facilities requiring long lead times are often made before drilling or firmly planning additional exploratory wells. In many cases, additional exploratory wells may no longer be required before a major project can commence because of information gained through the application of new technologies. The issue for the oil and gas industry is whether to apply the substantive principle of capitalizing beyond one year the cost of exploratory wells that find reserves or strictly adhere to the rule of expensing those wells if there are no additional wells underway or firmly planned for the near future. Most companies apply the substantive principle because to do otherwise would result in the premature expensing of costs for wells that would eventually become producing wells. This would have the impact of understating current and overstating future operating earnings.

Understanding the Current Environment for Major Exploration and Development Projects

As a result of the many changes affecting the industry in the past quarter-century since the promulgation of FAS 19, companies increasingly require more than one year to complete all of the activities that permit recognition of proved reserves under existing definitions and SEC guidelines. In order to understand better this environment a partial list of the industry's changes and the challenges that are routinely encountered in progressing multi-year developments are described below:

- Complexity of oil and gas projects
 - Exploration activities are frequently performed in more remote areas, to greater depths and in more complex formations. Drilling activities may also be further constrained due to seasonal factors (for example, drilling in Siberia) where the drilling season is very short and is often a matter of a few months per calendar year.
 - The range of recoverable hydrocarbons represents a much broader spectrum. Producing hydrocarbons differ widely in quality and can include a wider range of by-products, including sulfur, carbon dioxide, complex compounds containing hydrogen, sulfur and carbon as well as “associated gas” in oil reservoirs.

- Border issues require more negotiations among countries, regional jurisdictions and sometimes tribal councils. This occurs when multiple jurisdictions have joint ownership of mineral interests. Other times, one jurisdiction may own the mineral rights, but the transportation can only take place economically across the property owned by one or more other jurisdictions.
 - With the increasing scale of many international projects, more time is needed to obtain partner approvals and perhaps third party financing in advance of development activities. Plans for project development often are well advanced before proved reserves are recognized under current rules.
 - Especially for natural gas projects in remote international areas, long lead times accompany projects that require obtaining customer sales agreements in advance of development and, in some cases, plans for liquefying, transporting and regasifying the product.
 - Environmental concerns and requirements require greater industry investment and more time to comply with rules and regulations before a project can advance. In the United States, permits are often required at the local, state and federal levels. Multiple jurisdictions also exist in many other countries.
 - Discoveries are occasionally made in established areas with established or already planned infrastructure. While these wells have found commercial quantities of hydrocarbons, the timing of developments is driven by pipelines or facility capacity limitations. Development projects will occur, as capacity becomes available.
- Advanced technology
 - Technological advances in recent years have enabled the discovery and production of hydrocarbons from greater depths, especially offshore. However, additional lead time is often required for proof-of-concept testing. Also, in lieu of drilling, tools such as 3-D seismic measurement are sometimes being used to help to delineate the reservoir.
 - Given the broad spectrum of products and by-products now considered recoverable, complex processing facilities frequently must be constructed on or near the site of production to bring the hydrocarbons to the required specifications for transporting and to enable the processing of hydrocarbon by-products.
 - Government participation
 - Governments are more involved in the project-approval process in both developed and developing countries. As a result, project delays arise more frequently.

- In the past, countries outside the United States often granted concessions under which oil and gas companies would operate. More recently, governments have moved toward production-sharing agreements, which frequently result in protracted negotiations for project development activities.
- With more governments becoming partners in development plans, project delays often result from government financing difficulties and the number of government agencies involved.

Conclusion

API believes that industry practice of capitalizing successful exploratory wells is consistent with the underlying substantive principle of FAS 19 and should continue to be followed. Allowing the deferral of successful exploratory well costs for major projects only in circumstances when additional exploratory wells are planned or underway ignores the realities of the current environment. Instead, a broader interpretation of FAS 19 is needed to recognize that other pre-development activities such as obtaining reservoir data through seismic measurement, obtaining government approvals, negotiating sales contracts, and obtaining project financing can also delay the determination of proved reserves. Without this interpretation, essentially all exploratory wells for commercially successful long-lead-time projects would have to be expensed. At the same time, API also recognizes that the cost of successful exploratory wells cannot be deferred indefinitely on the hopes of increased prices or on the possibility that unplanned exploratory drilling might find additional reserves. API is hopeful that the EITF debate will result in workable guidance that will reflect these broad principles.

Very truly yours,



Richard H. Stock
Chair, Accounting Committee
American Petroleum Institute