Risk Insights

CECL
Implementation

Applying New Credit Loss Accounting Standard to Oil and Gas Companies

FASB'S NEW CURRENT EXPECTED CREDIT LOSS STANDARD (TOPIC 326), more widely known as CECL, makes sweeping changes in accounting for credit losses of financial assets. It moves away from the traditional model of "incurred losses" and toward an "expected credit loss" model, which requires a periodic evaluation of forecasted impacts.

The new standard applies not just to businesses that provide financing or invest in debt securities, but to all industries with financial assets, including oil and gas companies. With oil demand dropping significantly from the coronavirus pandemic coupled with excess market supply from Russian and Saudi Arabia, oil producers are facing significant pressure. A number of producers have filed for bankruptcy protection and more bankruptcies are likely in the future. These market conditions have made it more important than ever for companies to evaluate the impact on expected credit losses.

Determining the impact of CECL is subjective and requires a great deal of judgment, as assumptions and other considerations can be complex and difficult to quantify. Furthermore, while the standard specifies that loss recognition at some level will be more likely than under the incurred loss method, the factors used in determining expected losses will ultimately depend on the organization's documented rationale.

Even though implementation for most calendar year public registrants was required beginning January 1, 2020, some companies are just beginning to evaluate CECL's impact.

Since oil and gas companies do not typically have long-term receivables with complex financing arrangements and large credit exposure subject to long-term fluctuations in the market (e.g. reinsurance receivables or security lending agreements) the implementation of the standard will most likely not require complex financial models to estimate the expected losses. Prospective assessments for producers will likely be based on a few key variables such as commodity price. While this may be simpler, it will require additional context to communicate the organization's position on why the selected variable is the most relevant for forecasting expected credit losses.

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CECL Implementation

Companies that do not thoroughly analyze their financial asset categories could miss key considerations in adopting and evaluating the impact of the new standard. In doing so, they should either ensure that the assets are out of scope of the standard or prove that each asset has a minimal risk of loss.

For most independent oil and gas companies, the financial instruments that would be subject to the standard would be various trade receivables, producer/pipeline imbalances and revenue generating leases.

Here are some of the considerations that you should be evaluating as you prepare for your first financial reporting period under CECL:

Trade Receivables - JIB A/R

Receivables that are collateralized can narrow the scope of receivables subject to CECL

The standard allows you to consider collateral values in determining loss exposure, so if you have non-operators with enough revenue interests to offset any incurred expenses (albeit over a longer time span) you may be able to show that current receivables are collateralized by a partner's revenue interest. The difficulty here is evaluating changes to collateral value. Due to the defined span of returns, it is relatively easy to point to the type curves on the nature of the wells (e.g. well area, operator, and completion type) and perform a production revenue sensitivity analysis. For most independent producers, the majority of partners will fall into this category and may allow you to minimize the effort around JIB A/R if you can show that the balance of partners outside of this scope is insignificant. Furthermore, when carrying large receivables (especially in a contraction cycle like today's market) many operators utilize cash-calls to mitigate the risk of non-payment, which would be another avenue to reduce the default exposure in the CECL estimation process.

Receivables from Non-Operators

Risk profiles can vary significantly among non-operators, but there are some general themes. Classifying your JIB A/R between independent oil and gas company partners, investment organization partners, governments, foreign owned businesses, etc. allows you to structure criteria for partners based on a consistent risk profile. For example, independent oil and gas company partners would be likely to consider commodity prices as the largest driving factor to determine whether they would present an increased default risk, while other partners would utilize other financial measurement criteria such as credit history combined with qualitative factors. When classifying non-operators, organizations may consider the following receivable characteristics:

- Commodity Portfolio – companies that are largely focused in an only gas or only oil market would be more subject to default due to concentration risk
- Geographic Location – both internationally and domestically, are purchasers risk of default most aligned with events in that geographic region (e.g. the Argentinian geopolitical disturbance and nationalization of a private oil company)
- Partner Type – while many non-operators will likely be other operators, they may see significant investment from other types of organizations such as foreign governments and investment companies

Depending on the nature of operations, some organizations will be able to evaluate the JIB A/R as a single pool with one class or type of receivable. However, evaluating the different possibilities and documenting why they are not representative of the majority of the receivables is a strong strategy to support the organization's final determination.

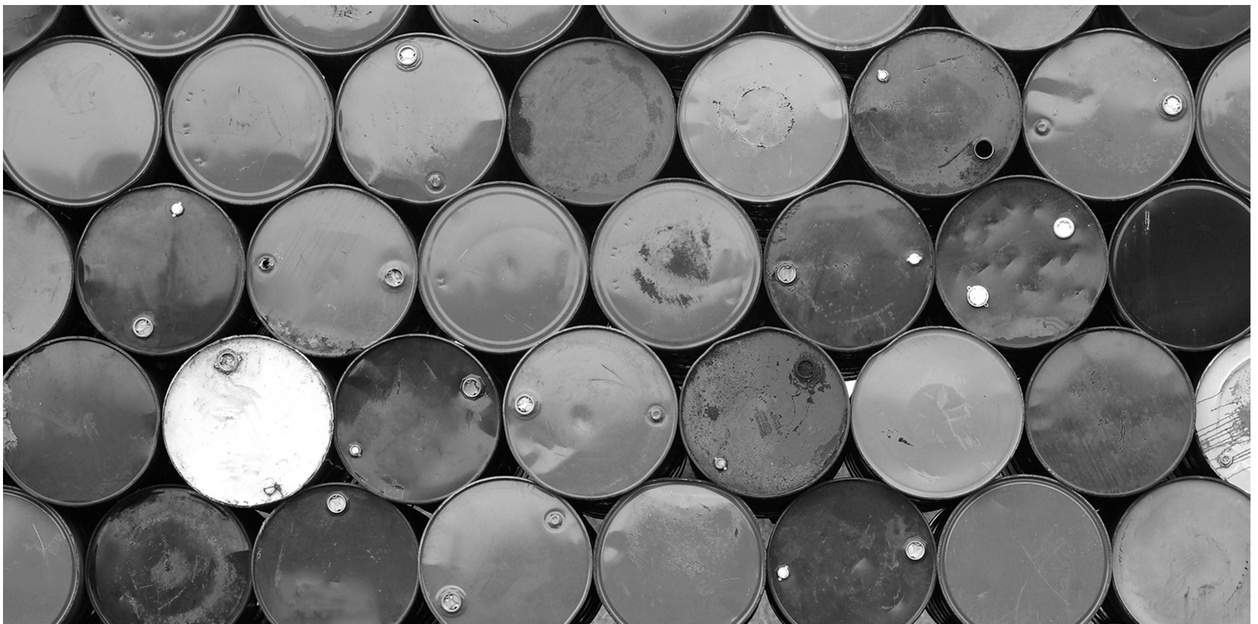
Trade Receivables - Purchaser A/R

Purchaser credit rating – many companies only sell to highly rated purchasers which may have local and/or national concentrations of exposure. For example, if your counterparty has a significant portfolio of west Texas intermediate, they would be highly subject to fluctuations or logistics issues in the Permian which may indicate a higher loss risk.

End User versus "middle man" – when evaluating the purchaser, consider whether they are the end user making the purchase based on funding from a downstream value-add process or if the purchaser is an intermediary managing on margin and dependent on a downstream sale to fund the purchase.

Producer / Pipeline Imbalances

While imbalances are often settled in the next month's nominations, CECL requires you to consider the potential loss related to these balances. In most cases, identifying the wells carrying an imbalance and determining they are not near the end of life or scheduled to be "shut-in" in the next period allows you to consider the collateral against the forecasted production. It's good to remember that the collateral estimate cannot be solely based on the value of the asset today but should also consider forward looking information such as forward pricing curves or estimated actual pricing based on the company hedge program.



Revenue Generating Leases

Especially in today's market, many organizations are "sub-leasing" office space, throw-down yards, or other physical assets that are idle. For those leases not classified as operating, the FASB clarifies that CECL is applicable and an evaluation to determine the likelihood of loss will be necessary. Organizations will need to evaluate the lessor's ability to meet the financial lease obligations by evaluating and understanding the risks specific to that lessor which may include understanding their available cash, availability of credit, commodity exposure or many other attributes to design an evaluation that would allow the organization to estimate the risk of loss.

Other Considerations

Transportation Contracts – Some organizations utilize gathering agreements or production handling agreements to offset the cost of infrastructure developed in highly concentrated fields. These agreements often have minimum flow requirements with a minimum penalty if a producer does not flow a certain level of bbls/mcfs per month. Receivables of this nature would need additional scrutiny as operators with shut-in production could represent a higher risk of loss.

Non-Consolidated Entity Guarantee – Some independent oil and gas producers act as guarantor for the debt of a non-consolidating joint venture, which falls under the CECL scope. If this situation applies, the guarantor must evaluate whether an expected credit loss arises from the guarantee, however this does not remove the guarantee from being subject to Topic 460 - Guarantees.

ALTHOUGH THE ADOPTION OF CECL is an in-depth evaluation of receivables, similar to both the leasing and revenue standards, organizations will need to design new processes on a go-forward basis to re-perform the analysis each quarter. For organizations with minimal exposure to the standard, this may only result in an additional control to refresh a CECL accounting memo outlining the minimal impact and highlighting that the assumptions continue to hold true. However, some organizations may need to include additional control activities that could range from lookback analyses of the actual losses against the expectation to validate their portfolio assumption to developing analytics based models that account for multiple factors to quantify the expected credit losses.

This list of considerations is not comprehensive, but it should address the common financial assets of independent oil and gas companies that may be subject to the new standard. For information about or assistance with CECL implementation, contact us.

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