

have been established or when those reserves become marketable? For instance, a determination of proved reserves may be made before completion of an extraction plant necessary to process sour crude or a pipeline necessary to market the reserves. May the costs continue to be excluded from amortization until the plant or pipeline is in service?

*Interpretive Response:* No. The proved reserves and the costs allocable to such reserves should be transferred into the amortization base on an ongoing (well-by-well or property-by-property) basis as the project is evaluated and proved reserves are established. Once the determination of proved reserves has

been made, there is no justification for continued exclusion from the full cost pool, regardless of whether other factors prevent immediate marketing. Moreover, at the same time that the costs are transferred into the amortization base, it is also necessary in accordance with Interpretation 33 and Statement 34 to terminate capitalization of interest on such properties.

In this regard, registrants are reminded of their responsibilities not to delay recognizing reserves as proved once they have met the engineering standards.

### 3. Full Cost Ceiling Limitation

#### *a. Exemptions for purchased properties*

*Facts:* During 20x1, a registrant purchases proved oil and gas reserves in place ("the purchased reserves") in an arm's length transaction for the sum of \$9.8 million. Primarily because the registrant expects oil and gas prices to escalate, it paid \$1.2 million more for the purchased reserves than the "Present Value of Estimated Future Net Revenues" computed as defined in Rule 4-10(c)(4)(i)(A) of Regulation S-X. An analysis of the registrant's full cost center in which the purchased reserves are located at December 31, 20x1 is as follows:

[Amounts in 1,000]

	Total	Purchased reserves	Other proved properties	Unproved properties
Present value of estimated future net revenues .....	\$14,100	8,600	5,500	.....
Cost, net of amortization .....	\$16,300	9,800	5,500	1,000
Related deferred taxes .....	\$2,300	.....	2,000	300
Income tax effects related to properties .....	\$2,500	.....	2,500	.....
		Including purchased reserves	Excluding purchased reserves	
Comparison of capitalized costs with limitation on capitalized costs at December 31, 20x1.				
Capitalized costs, net of amortization .....		\$16,300	\$6,500	
Related deferred taxes .....		(2,300)	(2,300)	
Net book cost .....		14,000	4,200	
Present value of estimated future net revenues .....		14,100	5,500	
Lower of cost or market of unproved properties .....		1,000	1,000	
Income tax effects related to properties .....		(2,500)	(2,500)	
Limitation on capitalized costs .....		12,600	4,000	
Excess of capitalized costs over limitation on Capitalized costs, net of tax ...		\$1,400	\$200	

\* For accounting purposes, the gross write-off should be recorded to adjust both the oil and gas properties account and the related deferred income taxes

*Question:* Is it necessary for the registrant to write down the carrying value of its full cost center at December 31, 20x1 by \$1,400,000?

*Interpretive Response:* Although the net carrying value of the full cost center exceeds the cost center's limitation on capitalized costs, the text of ASR 258 provides that a registrant may request an exemption from the rule if as a result of a major purchase of proved properties, a write down would be required even though the registrant believes the fair value of the properties in a cost center clearly exceeds the unamortized costs.

Therefore, to the extent that the excess carrying value relates to the purchased reserves, the registrant may seek a temporary waiver of the full-cost ceiling limitation from the staff of the Commission. Registrants requesting a waiver should be prepared to demonstrate that the additional value exists beyond reasonable doubt.

To the extent that the excess costs relate to properties other than the purchased reserves, however, a write-off should be recorded in the current period. In order to determine the portion of the total excess carrying value

which is attributable to properties other than the purchased reserves, it is necessary to perform the ceiling computation on a "with and without" basis as shown in the example above. Thus in this case, the registrant must record a write-down of \$200,000 applicable to other reserves. An additional \$1,200,000 write-down would be necessary unless a waiver were obtained.

#### *b. Use of cash flow hedges in the computation of the limitation on capitalized costs*

*Facts:* Rule 4-10(c)(4) of Regulation S-X provides, in pertinent part, that