

Takeaways From SEC Comments On New Oil, Gas Rules

Law360, New York (December 2, 2010) -- Effective Jan. 1, 2010, all public companies involved in oil and gas producing activities were required to comply with new oil and gas disclosure rules adopted by the U.S. Securities and Exchange Commission in December 2008.[1] The new rules represented the first changes to the oil and gas disclosure rules in approximately three decades.

In October 2009, the SEC Staff issued compliance and disclosure interpretations to assist oil and gas companies in their interpretation of the new rules and in their disclosure and reporting preparation.[2]

Throughout 2010, the SEC Staff (the "Staff") has offered additional guidance as the Staff reviews filings made by oil and gas companies after the effective date of the new rules and issues comment letters. The comment letters and related company responses generally become publicly available on the SEC's EDGAR website 45 days after the Staff has concluded its review.[3]

Based on a review of comment letters, we have compiled the following takeaways for public oil and gas companies to consider with respect to the new disclosure rules.

Prepare to justify determinations under the new SEC reserve definitions.

The definitions of "proved oil and gas reserves" and "proved undeveloped oil and gas reserves" ("PUDs") were significantly revised in connection with the adoption of the new disclosure rules. To confirm that companies are booking reserves in accordance with the new definitions, the Staff may ask how reserve determinations complied with the new definitions.

A company that books or intends to book PUDs that will remain undeveloped for more than five years should prepare to explain that determination, including:

- how the determination complies with the Staff's compliance and disclosure interpretations on the new PUDs definition;[4]
- the factors that limit the pace of project development;
- any environmental restrictions on development; and
- other factors that will likely cause development to take longer than five years.

The Staff may also request a detailed description of the nature, current status and planned future activities of the projects underlying the PUDs. A company with low historical PUD conversion rates should prepare to explain how it intends to develop its PUDs within five years of booking them as proved and what the conversion rates were for the prior three years.

In addition to the foregoing, a company should prepare to discuss its technology and pricing assumptions, including:

- disclosing the average number of offset locations away from an existing well that the company attributed to proved reserves and the evidence that supports the company's conclusion that the reserves are proved reserves;
- describing any alternative methods and technologies to production flow tests and to open-hole logs utilized to determine

gas-oil or oil-water contacts in determining material amounts of proved reserves added in the most recent year;

- for any alternative methods and technologies identified, describing why they are considered reliable in the geological environment employed as well as the amount of reserves added as a result of their employment; and
- explaining the procedures used to arrive at the 12-month average price for the determination of economic producibility of reserves.

Quantify and discuss all material changes to PUDs.

The new disclosure rules effectively require a "Reserve Discussion and Analysis," meaning that companies must disclose material changes in PUDs that occurred during the relevant year.[5]

The Staff noted numerous instances where this disclosure requirement was not completely satisfied. The Staff's comments indicated that companies must not only quantify all material changes but also discuss the reasons for the changes.

In addition to disclosing material changes due to conversions to proved developed reserves as specifically required by the disclosure rules, companies must also quantify and discuss reasons for all other material changes. Examples of other changes identified by the Staff requiring disclosure, if material, included those related to the following factors:

- removal of reserves scheduled for development beyond five years;
- positive performance revisions, discoveries, extensions and other additions;
- price, performance and deletions;
- improved recovery;
- acquisitions and divestments;
- determinations resulting from the new SEC oil and gas reporting rules; and
- investments made to develop PUDs.

Review and verify third-party reserve reports.

Under the new disclosure rules, a company must file a third-party reserve report containing specified information as an exhibit to the relevant filing if it indicates that a third party prepared or audited the company's reserves estimates or any estimated valuation of the estimates or conducted a process review.[6] The Staff identified numerous issues in third-party reserve reports.

The Staff focused especially on language that appeared to limit the ability to rely on the reserve report to only the public company. The Staff's concern was that the language appeared to limit an investor's ability to rely on the report.

Although most of the Staff comments related to the new oil and gas disclosure rules were "futures" comments (i.e., requests that companies address the comment in future SEC filings rather than amend the report), the Staff generally required an amended filing and a new reserve report that removed this limiting language.

Other issues the Staff identified in its review of reserve reports included:

- Reserve reports should include the numerical 12-month average benchmark prices and average adjusted prices used in the reserves calculation along with price assumptions.
- The Staff took issue with any reference in the text of the reserve report as well as the SEC filing itself to "generally accepted petroleum engineering and evaluation principles." The Staff noted that, unlike GAAP for accounting matters, it was not aware of any official compilation of such principles. In certain instances, the Staff accepted a response referencing

the Society of Petroleum Engineers' February 2007 publication entitled "Standards Pertaining to the Estimating and Auditing of Oil and Gas Reserves Information" as the source of the "generally accepted petroleum engineering and evaluation principles" along with an undertaking by the company to specifically refer to these standards in future reserve reports and SEC filings. However, the Staff's more recent letters did not accept this approach and instead required removal of the disputed language. Some companies satisfied the Staff either by removing the disputed language or by replacing it with the phrase "appropriate engineering, geologic and evaluation principles and techniques that are in accordance with practices generally accepted in the petroleum industry." In order to avoid a future Staff comment, a company should consult with its independent petroleum engineers to seek out alternative language rather than continue to utilize the disputed "generally accepted petroleum engineering and evaluation principles" in the reserve report and SEC filings.

- The Staff requested disclosure of the aggregate percentage difference between a company's proved reserve estimates and those of the third-party engineer, even though such disclosure is not explicitly required by the new disclosure rules. A company should retain a reconciliation in its files of any such differences.
- The Staff requested confirmation not only that the independent petroleum engineers had used all methods and procedures considered necessary under the circumstances to prepare the reserve report, but also that language to that effect was included in their reserve report as required by the new disclosure rules.
- The Staff has questioned any language that purports to exclude from the independent petroleum engineer's consideration any legal or accounting matters in connection with the preparation of the reserve report. The Staff asked that any such language be either removed or revised to make clear that the engineers are not holding themselves out to be accounting or legal experts for the purposes of the reserve report and their opinion.

In light of the issues raised by the Staff concerning the wording of reserve reports, companies should confer with their independent petroleum engineers to confirm that the engineers are aware of the various Staff comments on reserve reports. In order to avoid filing a revised reserve report, the wording of reserve reports should address relevant disclosure rules and the Staff comment letters.

Properly describe scope of review performed by independent petroleum engineer.

A company should ensure that the reserve report as well as any language contained in the SEC filing clearly indicate that a reserves audit (as defined in the new disclosure rules), as opposed to a process review, was performed. If a process review was performed, a company should disclose the actions that comprised the review.

Consider Staff guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). Although the Staff focused primarily on compliance with the new oil and gas definitions and line item disclosure requirements, it also issued a few comments reminding companies of their MD&A disclosure obligations regarding oil and gas matters. The SEC did not adopt (as originally proposed) new MD&A disclosure requirements for oil and gas matters, but did issue MD&A guidance in the form of a list of topics that a company may need to discuss.

The Staff's guidance indicated that a company is only required to discuss a topic if it otherwise meets the standards for MD&A disclosure, meaning that it "constitutes, involves, or indicates known trends, demands, commitments, uncertainties, and events that are reasonably likely to have a material effect on the company." [7]

A company should review the Staff's guidance when drafting MD&A and address each of the topics identified in the guidance, if applicable. Examples of disclosures requested by the Staff in the comment letters as a result of the MD&A guidance included:

- the amount of PUDs that were developed in the last three years if historical PUD conversion rates were significantly lower than the rate necessary to convert all PUDs to proved developed reserves within five years;
- historical conversion rates for probable reserves to proved reserves when probable reserves are disclosed; and
- information about the typical initial rates and decline rates of wells for material projects and whether the rates are similar to other wells in other sections of a field.

Ensure that data gathering systems have been updated.

The Staff has issued comments indicating that companies had not complied with the new disclosure requirements, either in full or in part. Accordingly, companies should ensure that their data gathering systems have been updated to collect all of the required information required by the new disclosure rules. Furthermore, companies should ensure that they are familiar with the new disclosure rules to ensure that all required information is being reported.

Royalty trusts should comply with the new disclosure requirements.

The SEC believes that publicly traded royalty trusts should comply with the new oil and gas disclosure requirements for the properties underlying the royalty interests, even if the trust only earns royalty interests and is not responsible for any well development activities.

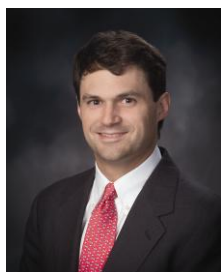
The takeaways discussed above do not address all of the specific issues raised by the Staff in its 2010 comment letters. Furthermore, the Staff will likely address other issues in future comment letters or by issuing new or updated compliance and disclosure interpretations.

However, public oil and gas companies should review the publicly available comment letters regarding the new disclosure rules and related company responses, especially those of peer companies, to identify specific comments that may apply directly to their own oil and gas disclosures. By identifying the oil and gas disclosure issues identified by the Staff during the comment letter process, companies may be able to address oil and gas disclosure issues proactively in future filings and therefore potentially avoid Staff comments and possible amendments to their SEC filings.

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The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media, publisher of Law360.

[1] Modernization of Oil and Gas Reporting, Exchange Act Release No. 34-59192 (Dec. 31, 2008) (“Adopting Release”).

[2] Oil and Gas Rules Compliance and Disclosure Interpretations (Last Updated Oct. 26, 2009) (“Interpretations”).

[3] SEC Staff comments are identified by the filing code “UPLOAD.” Company responses are identified by the filing code “CORRESP.”

[4] Interpretations at Question 108.01 and Questions 131.03 – 131.06.

[5] 17 C.F.R. § 229.1203(b) (2009).

[6] 17 C.F.R. § 229.1202(a)(8) (2009).

[7] Adopting Release at 86-87.